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Australian Energy Market Commission
PO Box A2449
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Dear Commissioners

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

The Consumer Action Law Centre (**Consumer Action**) welcomes the opportunity to comment on the Australian Energy Market Commission's (the **Commission**) *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets – First Draft Report* (the **First Draft Report**) which was released for consultation on 4 October 2007.

Background

In the Executive Summary of the First Draft Report, the Commission states:

The Commission's preliminary finding is that competition in both electricity and gas retailing in Victoria is effective. 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.

We believe that the Commission's findings are flawed, reflecting the poor level of analysis conducted to prepare the First Draft Report. The analysis of demand side interaction with the market is highly inadequate and, as such, does not provide sufficient evidence that competition in both electricity and gas retail markets is effective.

We emphasise the need for the Commission to conduct further, in-depth research of consumer engagement in the energy market. This research should investigate the widespread problems associated with direct marketing techniques and clearly determine whether Victorian consumers are making choices that are in their best interests. Without such analysis, we do not believe that the Commission can conclude that Victorian electricity and gas retail markets are in fact competitive.

Our submission covers the following areas:

- The essential nature of energy;
- Commission's framework for analysis;
- The failure to adequately consider the experience of demand side;
- Retailer rivalry;
- Conditions for entry, expansion or exit;
- Profit margin analysis; and
- Equitable access to benefits of competition

We implore the Victorian Government and the Ministerial Council for Energy to carefully consider the content of the Commission report with an awareness of author bias and agenda, and to listen carefully to the concerns of consumer groups. Such groups deal with consumers affected daily by the energy market, in particular, the current practices of direct marketers. We are concerned that the Commission's misconception of the issues relating to direct marketing largely forms the basis of its premise that competition in Victoria is effective.

The essential nature of energy

Consumer Action believes that the Commission has not fully appreciated the nature of energy and the fact that the market for energy is in many ways unique. Energy is an essential service used by all consumers across Australia. Except in rare and exceptional circumstances, a regular connection to electricity supply is not discretionary or optional. In most instances there is no alternative to electricity. Electricity supports fundamental human needs including safe food (storage, preparation) and safe shelter (hygiene, lighting, temperature control). Electricity supports equipment that is critical to wellbeing and independence (health, communication). Beyond these fundamentals, electricity supports community engagement and family life (social interactions, employment and education).¹ Gas is increasingly becoming more essential, especially in Victoria, where many households rely upon gas for cooking, hot water and as a low cost alternative for heating.

The Commission does recognise that energy differs from other goods and services as it is an undifferentiated,² low involvement commodity.³ However, the Commission merely notes this as requiring a different approach to engage consumers in active market participation (that is, through direct marketing).

Upon introduction of full retail contestability (**FRC**) in 2002, recognising the essential nature of energy, the Victorian Government implemented the 'safety net' as a fundamental protection for Victorian consumers. Since 2002, this protective measure has served to ensure consumers remain connected to an energy supply, at a fair, regulated energy price (the standing offer price). Competition has benefited Victorian consumers by encouraging retailers to price below the regulated price to maintain custom. We note that the Victorian

¹ National Consumer Roundtable Energy, *Charter for the Principles of Energy Supply*, November 2006.

² AEMC, *Review of the effectiveness of competition in retail electricity and gas markets in Victoria – First Draft Report*, October 2007, p 41

³ As above. p vii

Government has recently extended the safety net to the end of 2008 while it waits for the final recommendation of the Commission.

In the First Draft Report, the Commission has indicated it will recommend the removal or phasing out of the standing offer pricing arrangements. Even if we did agree with the Commission's preliminary conclusion that competition is effective, Consumer Action continues to be concerned that should pricing regulation be removed, consumers with the least opportunity to actively engage in the market, through low income and vulnerable status, will be disadvantaged and will no longer be ensured price protection on the purchase of an essential service.

Should the Victorian Government choose to proceed with a deregulated market structure, we recommend with urgency the implementation of a pricing policy that will guarantee consumer protections for access to energy. Even if the current standing offer pricing arrangements are dispensed with, we urge consideration of alternative regulation of pricing, perhaps through the implementation of pricing principles. We believe it is incumbent on the Commission to consider such alternatives in its advice to the Victorian Government.

Commission's framework for analysis

As stated in our introduction, we believe that the Commission's framework for analysis is flawed. We are concerned that the report has been presented with an underwritten agenda and bias in favour of a finding of effective competition. We are particularly concerned about the Commission's framework for analysis that assumes that once a finding that competition is effective, it automatically follows that retail pricing regulation should be removed. We have consistently raised this concern with the Commission, both in our submission to the Commission's Draft Statement of Approach and in our submission to the Issues Paper. We do not believe that the Commission has substantively engaged with this argument.

The Commission states that

Where competition is effective in promoting economic efficiency, there is no need for regulatory intervention. Regulation is costly, in terms of both administration and possible distortions to competitive market processes.⁴

While this is generally true according to economic theory, it must be acknowledged that not all markets are homogenous. In particular, Victoria's electricity and gas markets are unique and energy itself is not a homogenous product. On this basis, the Commission's entire premise fails to acknowledge the necessity of regulatory intervention to ensure that two key issues, not considered by traditional economic theory, are dealt with:

- That energy is affordable, in recognition of the fact that it's an essential service; and
- That we must encourage conservation of energy to reduce consumer costs and greenhouse gas emissions.

While it is possible that economic theory could be used to determine the market is competitive, we contest the assumption that this should automatically lead to price

⁴ As above, p 14

deregulation. It is our view that it is erroneous for governments and regulators to automatically presume particular regulatory interventions (or non-interventions), without considering the entire market, including any special qualities in that market, such as the two outlined above.

To address this, Consumer Action believes that Australian regulatory processes need to incorporate international best practice about when to intervene in markets.

The Organisation for Economic Co-operation and Development (**OECD**) Consumer Policy Committee has developed a comprehensive checklist and toolkit for assessing regulatory change which begins with questions assessing both the supply side and the demand side of the market. The demand-side questions reflect modern understandings of consumer experience and behaviour, including: “Is the market sound?”, “Are consumers enjoying the benefits of a competitive market?”, “Is there information failure?” and “Are there behavioural biases affecting consumer decision making and outcomes?”.

The next step in the checklist involves analysing whether informational instruments, behavioural instruments or other instruments are required. Importantly, the decision tree recognises that more than one type of tool can be used to address demand-side issues. If the analysis finds that the benefits of intervention (to empower or protect consumers) would outweigh the costs then a policy response for improving the market for consumers is recommended. If the analysis finds that the costs of intervention would outweigh the benefits, then a further analysis is still required – to assess whether costs are falling on vulnerable or disadvantaged groups. If so, then policies to compensate or protect these consumers are recommended.

Rather than automatically presume the phasing out of price regulation when a finding of effective competition is made, we believe that the Commission should use this framework to assess what sort of price regulation would be required to ensure the Victorian energy market remains competitive. Copies of the OECD materials are attached at Appendix A.

Failure to adequately consider experience of demand-side

In its analysis of ‘effective competition’, the Commission focuses on the economic efficiencies of supply side to reach its conclusion that the Victorian energy market has effective competition. It is our view that the First Draft Report does not place sufficient weight on the necessary involvement of the demand side, a crucial element of market balance. Although the Commission does examine customer participation and experience in Chapter 6 of the First Draft Report, we believe that it summarily dismisses much of the evidence presented.

The Commission commissioned the Wallis Group to conduct a survey of 1000 domestic users and 500 business users to demonstrate demand side participation. The Wallis Group found that ‘only 10 per cent of domestic customers had contacted an electricity retailer and 6 percent a gas retailer over the last five years ... [and] customer initiated contact remains steady at 6 percent’. We believe that this finding is telling in relation to demand side participation – in our view, high levels of customer initiated contact indicates a demand side

that is informed and is actively seeking the benefits of competition. Such a level of informed engagement is missing from the Victorian energy market.

The Commission acknowledges low levels of demand side participation impinging on the ability for the market to operate effectively when it stated:

Given the homogenous, low involvement nature of energy supply, many customers do not consider the time, effort and cost of searching for alternative supply options to be worth the potential gains that could be made from switching supplier.⁵

The findings of the Wallis Group survey also identified 40 per cent⁶ of domestic consumers that have remained on a standing offer, noting that they are unmotivated to switch 'as they are not interested in the market'.⁷ Additionally, 19 per cent of domestic customers have switched because they have moved house.⁸ These figures mean that there is over 50 per cent of the market who are unengaged, or are switching based upon circumstance, not necessarily active choice.

We believe that these figures should be further considered in determining the effectiveness of competition, particularly with the heavy reliance on direct retailer contact to drive churn. In fact, in the Wallis Group retailer survey, a first tier retailer notes the reliance on direct door-to-door sales to drive churn:

In the last 12 months in Victoria, (there's been) big churn of over 25% which is remarkable at this stage in the marketplace. If all activity stopped, if all push activities say door knocking, telemarketing, direct mail and the likes, stopped, from what we've seen, this churn will probably drop to below 5%, generally, and that's what we're seeing in other markets around the world.⁹

Considering this, it appears that the Commission bases the entirety of its argument for effective competition and demand side participation on the narrow shoulders of direct marketing. It states that any engagement with consumers relies upon retailers attempts to 'overcome customer disinterest through direct marketing campaigns',¹⁰ more specifically, door-to-door and telemarketing sales.

Consumer Action strongly believes that a reliance on direct marketing for a finding of effective competition is inappropriate. The Commission notes that several markets rely on direct marketing, citing examples such as telecommunications, healthcare, cosmetics and education.¹¹ To rely on such comparisons is flawed and demonstrates a significant misunderstanding of the nature of direct marketing. Consumer Action's casework experience demonstrates significant problems with direct marketing in many of these industries. In particular, we are concerned about the 'psychological techniques' being used

⁵ As above, p 69

⁶ Wallis Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets Consumer Research Report* August 2007 p.iii

⁷ As above, p.iv

⁸ As above, p 32.

⁹ Wallis Group, *AEMC Review of Competition in the Gas and Electricity Retail Markets Retailer Study Research Report* p. 25

¹⁰ AEMC, above n 2, p 108

¹¹ As above, p., 69

by marketers in some of these industries (eg, education software), which results in consumers making very poor choices.¹²

In the First Draft Report, one retailer acknowledges that consumers need to be directly marketed to, to the extent of being bothered or 'harassed' in order for sales to be achieved:

unless you bother someone, then you're kidding yourself. They're just not going to come looking for you."¹³

To us, this comment demonstrates that retailers will always have to overwhelm the will of a consumer to make a sale.

Consumer Action's forthcoming report '*Coercion and harassment at the door: Consumer experiences with energy direct marketers*' provides evidence that there are widespread problems resulting from direct marketing in the Victorian energy market, specifically door-to-door sales. The marketing activity of many retailers has resulted in widespread breaches of the *Energy Retail Code* and the *Code of Conduct for the Marketing of Retail Energy* which expose consumers, particularly low income and vulnerable consumers, to situations where they may not be able to make an informed choice when confronted with a sales person on their doorstep. Our report details 28 case studies, and is supported by complaints data from the Energy and Water Ombudsman (Victoria) (**EWOV**), demonstrating the inability of door-to-door sales to bring about competitive outcomes. The significant levels of unconscionable conduct and misleading representations means that consumers are unable to make decisions that are in their best interests, resulting in a market that is not provided with appropriate signals about the sorts of products and services consumers desire.

Our report highlights the issues with direct marketing in other industries, such as financial services, and their subsequent proscriptive regulation. We conclude that the reliance on direct marketing, in its current form, will undermine effective competition and increase the level of social inequality, acting as a barrier to the efficient provision of an essential service. We will make the report available to the Commission after its forthcoming release. The report will be released in conjunction with a 'Do Not Knock' campaign, designed to improve consumers' ability to protect themselves from door-to-door marketing.

We note that the Commission recognises that there may be 'instances' where retailers are not complying with relevant codes or guidelines, but argues that the ESC's performance reports indicate a 'high degree of compliance' across the market. The Commission unfairly dismisses other evidence provided by the Footscray Community Legal Centre and EWOV about systemic issues in relation to direct marketing,¹⁴ preferring to conclude that there is a 'relatively low level of complaints'.

A recent report on consumer detriment by Consumer Affairs Victoria (**CAV**) found that only 4 per cent of revealed consumer detriment is reported to CAV, the primary body for recording

¹² See, eg, Michelle Innes, 'Do the maths before signing up' *Brisbane Times*, 17 October 2007, available at: <http://www.brisbanetimes.com.au/news/planning/do-the-maths-before-signing-up/2007/10/15/1192300680687.html?page=fullpage>.

¹³ AEMC, above n 2, p 62

¹⁴ As above. p 75

consumer complaints in Victoria.¹⁵ Smaller percentages are referred to other parties such as ombudsman, and 26 per cent do not make any complaint at all. Considering this, and the evidence tendered by us and other organisations, we believe that complaint levels mask widespread misconduct by energy marketers. We fail to understand why the Commission has preferred some evidence tendered to reach its conclusion over others, particularly as, based upon the CAV report, the level of complaints provided to EWOF are a reliable indication of wider occurrences in the marketplace.¹⁶ We believe it is imperative for the Commission to reconsider its preliminary conclusion in relation the level of marketing misconduct and its impact on effective competition.

Despite the low level of interest in energy as a commodity, and insufficient analysis of demand side participation, the Commission argues that if there is 'enough' engagement with the competitive market, this will be sufficient to ensure competition. This may be true, but based upon the results of the Wallis survey, we question the Commission's definition of 'enough', when over half of those surveyed, as detailed previously, were either not engaged, or switched because of moving house.¹⁷ Further to this, the Commission also notes that

There may be certain customers that, due to a range of individual and broader social circumstances, are not able to access the full benefits of competition.¹⁸

In light of this, and considering energy is an essential service, we do not think it is sufficient for the Commission to state that 'enough' consumers engaging with the market is a valid or reasonable premise on which to base the recommendation of effective competition.

Victoria has been reported as being the 'hottest' market in the world,¹⁹ based on having the highest switching rate in the world. We note, however, that the Commission recognises in its First Draft Report that the rate of multiple switching is significant, with 30% of customers switching twice or more.²⁰ It is our view that high levels of multiple switching is a further indicator of consumers not making choices that best suit their needs.

In our view, the low engagement of consumers in the energy market will mean that the supply side will retain control over market prices and competitive outcomes will be impinged. As evidenced in recent incidences in the USA, a number of those states that removed regulation have reintroduced regulation based upon the exorbitant energy prices market contracts introduced, driving households into hardship.²¹

Retailer rivalry

The Commission's First Draft Report argues that effective competition is evidenced by a strong degree of 'price rivalry between retailers'. The Commission argues that the application of different pricing structures is a good thing as it 'improve(s) choice for

¹⁵ Consumer Affairs Victoria, *Consumer detriment in Victoria: a survey of its nature, costs and implications*, October 2006 p.9.

¹⁶ As above.

¹⁷ Wallis Group, above n 6, p.iv-v

¹⁸ AEMC, above n 2, p 139

¹⁹ First Data Utilities, World Energy Retail Market Ranking, July 2007, p. 1

²⁰ AEMC, above n 2, p 87

²¹ David Cay Johnston, 'A new push to regulate power costs', *New York Times*, 4 September 2007, available at: <http://www.nytimes.com/2007/09/04/business/04energy.html?source=cmail&r=1&th=&r=3&adxnnl=1&emc=t&oref=slogin&pagewanted=1&adxnnlx=1190190155-12R2VZrKAej8zleVL88QQ>.

consumers and allow(s) tariffs to more accurately reflect the cost of servicing different types of customers'.²² We believe that this statement misunderstands the information consumers need to make decisions about their best interests.

Innovation in tariff design will further complicate the process of consumer decision making. With the absence of a benchmark standing offer for comparison and limited to the information provided to them by retailers, consumers are faced with no means to decipher tariff designs due to their complexity or variability, and will make it difficult for consumers to make decision in their interests.

The current standing price arrangements has played a significant role in enabling retailers to approach consumers with market contracts, providing a comparison or reference point for consumers to determine savings. The elimination of the standing offer will undermine the effectiveness of competition as there is no comparison point for savings, consumers will have no confidence that they are receiving the best deal, and there will be no regulation on energy prices, with the market purportedly functioning to drive down prices.

While the Essential Services Commission's (ESC) Energy Product Disclosure Guideline attempts to ensure that retailers present tariff information in a consistent fashion, offers are still presented in complex ways. For example, offers' fixed and variable charges vary, the mode of charging varies (per week, per quarter, per kWh) and discounts from a particular rate will only be effective if consumers are on or understand the reference rate to begin with.

Further, there is no mechanism for easy comparison between particular offers. The ESC and the Essential Services Commission of South Australia (ESCOSA) comparator tools, as acknowledged by the Commission, are difficult for consumers to use. The ESC comparator tool compares new offers against an account holder's existing bills, not against the range of offers in the market and whilst the ESCOSA estimator provides a good analysis across market offers, it is price based only and does not enable users to understand important non-price terms and conditions at quick glance. We are aware of a number of internet brokerage tools currently under development that will aid consumers by providing access to information and comparative data. We note that no such brokerage tool is currently in operation in Victoria, and their ability to succeed will depend on whether all retailers agree to participate. It is our understanding that the primary delay in establishing these tools has been because retailers do not want to participate, with some of the incumbent retailers preferring to maintain their competitive advantage by not enabling consumers to have transparent information to aid them switch. Comprehensive access to the internet is also necessary for consumers to benefit from these tools.

Retailers also engage in non-price rivalry – currently the biggest focus is the provision of green energy. With the varying levels of green energy that can be selected, the levels of accreditation for green power, the price premiums attached to purchasing green energy etc, the tariff structures are increasingly complicated and often misleading. Despite the existence of accredited GreenPower, we are still seeing sales of "renewable" energy that is not accredited.²³ Similarly, some companies offer a non-accredited portion (usually called

²² AEMC, above n 2, p 60

²³ See, eg, Red Energy which sells "100% renewable energy" from Snowy Hydro.

the 'backfill') and market these products as "100% renewable".²⁴ We believe that these marketing strategies are consciously designed to confuse consumers and take advantage of consumers' desires to be environmentally friendly. We note that the Public Interest Advocacy Centre, acting for environmental group Total Environmental Centre (TEC), has made an official complaint to the Australian Competition and Consumer Commission about the environmental claims in the advertising of some renewable products.²⁵ TEC alleged that several companies misrepresented the environmental benefits of their products and engaged in misleading advertising. While some of the offending products have already been withdrawn from the market following this complaint, many consumers are still signed up to these products. It is our view that misleading marketing of green products significantly inhibits effective demand side participation in the energy market.

Conditions for entry, expansion or exit

We believe that regulation does not operate as a barrier to entry or expansion, but agree that it should be reviewed regularly to ensure efficiency and applicability to the current market. We agree with the Commission's analysis that current regulation in Victoria does not operate as a barrier to entry, expansion or exit to the market for retailers.

While undertaking some analysis on the impact of current retail pricing regulation, the Commission's First Draft Report does not consider how market offers or price regulation could operate with new market developments. There is no analysis on the impact of the proposed rollout of advanced meters in Victoria which may be accompanied by radical tariff reforms, and the increased costs that will be passed through to consumers through the proposed national Emissions Trading Scheme (scheduled for 2012 or before). There is a strong likelihood that these reforms will increase costs for consumers. We believe it is irresponsible not to conduct a full economic and social analysis of the impact these reforms which, combined with a deregulated retail pricing environment, may place many consumers in a vulnerable financial position.

We note that some consumer groups have begun thinking about pricing principles that should operate in the context of these market reforms.²⁶ We strongly support these initiatives and urge the Commission to engage with consumer groups in a debate about appropriate retail price protections.

The First Draft Report briefly discusses regulation that promotes better management of customers experiencing financial hardship, and indicates it will provide advice about 'transition arrangements' that will support assistance for vulnerable customers. We continue to support the requirement of retailers to provide hardship support, and are supportive of the Victorian regulation that has been introduced in this regard. It is our view that such targeted protection does not create an unreasonable impost on businesses. Rather the policies require retailers address hardship where it occurs, without placing limits on the overall functioning of businesses. We do acknowledge that the requirement to provide appliances to hardship customers following an energy audit may be a role more appropriately managed

²⁴ See, eg, AGL's Green Living and Green Spirit products.

²⁵ Elissa Freeman, 'Navigating the green energy market', *On the Wire*, January 2007.

²⁶ See, eg, Consumer Utilities Advocacy Centre, *Forum Papers – Expert Forum on Electricity Pricing*, August 2007.

by government. However, it is our understanding that the actual purchase of appliances has been minimal, with the requirement ensuring retailers make more use of the Government's capital grants scheme to support consumers. We believe this is an effective and efficient outcome.

Profit margin analysis

We welcome the preliminary analysis from CRA on the estimated average retail profit margins. We look forward to the final analysis, which will be integral to any decision about the effectiveness of competition in the energy market.

We note with interest that the preliminary analysis shows that under the standing offer tariffs for electricity, margins have generally risen since 2004. Also, the preliminary analysis shows that the current standing offer tariffs have not prevented efficient new entrants from operating profitably. This supports our argument that the standing offer arrangements do not automatically need to be reviewed should competition be found to be effective – instead the standing offer may be supporting the level of competition that exists.

We also note that recent Independent Pricing and Regulatory Tribunal (**IPART**) analysis highlights that retailers can sustain rising wholesale costs. This was informed by analysis from Frontier Economics, which demonstrated that most retailers are substantially hedged (and may be even over-hedged) so as to manage wholesale price risks.²⁷ We hope that the CRA analysis will consider the extent to which retailers are currently hedged in their analysis.

We note the Commission's qualifications about the data on retailer margins, noting that the inaccessibility of data that is commercial confidential limits its ability to understand the costs for business. Given the significance of the shift to full deregulation and the impact on Victorian consumers (and all Australian consumers as this model is rolled out nationally), we believe that retailers should be required to provide more information about the extent of their profit margins (even confidentially to the regulator), to ensure consumers are receiving the most effective and efficient prices.

Equitable access to benefits of competition

We welcome the inclusion of analysis about the sharing of benefits of competition. However, we believe that by highlighting that 'certain categories' of consumers may not be receiving the full benefits of the competitive market, the Commission is undermining its finding that there is effective competition.

The Commission notes that some consumers may be further discriminated due to a deregulated market that relies on competition. Factors impacting disadvantage include location, usage patterns and credit history, specifically those in regional and rural areas.²⁸ Why it is pleasing to see that the Commission has acknowledged this disadvantaged, we are

²⁷ Frontier Economics, *Analysis of recent changes in NEM wholesale electricity prices*, May 2007, 7.

²⁸ AEMC, above n 2, p 141

not convinced that the Commission has adequately considered the ways in which this disadvantage might be exacerbated should pricing regulation be removed.

We also welcome the Commission's acknowledgment that consumers experiencing financial hardship or personal disability may not be benefiting from the competitive market. We are concerned, however, that the Commission has focused on permanent hardship and disregarded temporary hardship. We note that the level of hardship of consumers varies depending upon particular circumstances. The concept is fluid and can apply to a range of consumers over a period of time.²⁹

The Commission's statement that the information available during the Victorian review has not indicated that non-English speaking background (NESB) consumers are disadvantaged in a competitive energy retail market is broad and sweeping. The Commission has not presented clear evidence to support this, and it is at odds with (or ignores) the levels of complaints received by EWOV by consumers of a NESB in relation to direct marketing conduct.³⁰

The Commission states that issues of managing disadvantages from competition fall outside of the scope of the review and refer them to the Victorian government. Considering the potential impact of the removal of retail price regulation, we do not believe this is appropriate. It is important that in the ultimate policy advice provided to the Victorian Government, that the Commission makes it clear where the market is not effective and how this should be addressed, because the benefits of competition are not shared across the entire customer base.

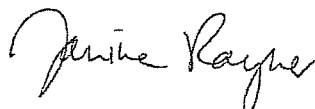
Should you have any questions about this submission, please contact us on 03 9670 5088.

Yours sincerely

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²⁹ For more information about energy hardship, see Independent Committee of Inquiry, *Financial Hardship of Energy Consumers – Main Report*, September 2005.

³⁰ AEMC, above n 2, p. 142