



**MONITORING THE  
DEVELOPMENT OF  
ELECTRICITY RETAIL  
COMPETITION IN SOUTH  
AUSTRALIA  
PROPOSED APPROACH**

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**ELECTRICITY**



## **REQUEST FOR SUBMISSIONS**

The Essential Services Commission of SA (ESCOSA) invites written submissions from interested parties in relation to the issues raised in this paper. Written comments should be provided by **Friday 30 May 2003**. It is highly desirable for an electronic copy of the submission to accompany any written submission.

It is ESCOSA policy to make all submissions publicly available via its website ([www.escosa.sa.gov.au](http://www.escosa.sa.gov.au)), except where a submission either wholly or partly contains confidential or commercially sensitive information provided on a confidential basis and appropriate prior notice has been given.

ESCOSA may also exercise its discretion not to exhibit any submission based on their length or content (for example containing material that is defamatory, offensive or in breach of any law).

Responses to this paper should be directed to:

### **Monitoring the Development of Electricity Retail Competition in SA**

#### **Proposed Approach**

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### **Public Information about ESCOSA's activities**

Information about the role and activities of ESCOSA, including copies of latest reports and submissions can be found on the ESCOSA website at [www.escosa.sa.gov.au](http://www.escosa.sa.gov.au).



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## **1. INTRODUCTION**

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### **1.1 General**

The primary objective of the Essential Services Commission of South Australia (“ESCOSA”) under the *Essential Services Commission Act 2002* is the protection of the long term interests of South Australian consumers with respect to the price, quality and reliability of essential services. The sale and supply of electricity to consumers at the retail level is one of the essential services within the regulatory scope of ESCOSA.

In protecting these long-term interests, ESCOSA is required to have regard to the need to:

- ▲ Promote competitive and fair market conduct;
- ▲ Prevent misuse of monopoly or market power;
- ▲ Facilitate entry into relevant markets;
- ▲ Promote economic efficiency;
- ▲ Ensure consumers benefit from competition and efficiency;
- ▲ Facilitate maintenance of the financial viability of regulated industries and the incentive for long-term investment; and
- ▲ Promote consistency in regulation with other jurisdictions.

If ESCOSA is to protect the long term interests of South Australian consumers, and given that the electricity retail market in South Australia is now based on the concept that competition will ultimately provide the best protection for consumers, then it is important for ESCOSA to monitor the state of competition in the South Australian electricity retail market.

The purpose of this Proposed Approach paper is to set out ESCOSA’s views on the appropriate means of doing this, to seek stakeholder input on those views and any other matters which might be considered relevant to a study of this nature and to indicate some of the potential uses for information gained.

### **1.2 Contestable v. Competitive markets**

On 1 January 2003, the South Australian electricity retail market became fully contestable. This means that there are no longer any direct legal or regulatory impediments in place which prevent an electricity retailer seeking to sell electricity to a South Australian customer. Up until this date however, the market was partially contestable, as certain customer classes, defined by reference to annual electricity consumption, were shielded from competition. The extension of contestability to all South Australian electricity customers was a process which occurred across some five years, starting from the largest users of electricity and moving eventually to the smallest users (domestic and small business customers).

Nevertheless, while the South Australian electricity retail market is now fully contestable, there is a difference between a contestable retail electricity market and a competitive electricity retail market.



A contestable market may be thought of as one where any electricity retailer has the potential to enter and compete for the patronage of any customer without legal impediment. It is important to bear in mind that ESCOSA is talking here only of legal barriers to selling electricity, rather than any other barrier which may otherwise exist.

On the other hand, a competitive market might best be considered as one which displays the characteristic of unconstrained rivalry by competitors seeking to obtain or expand market share.

So what then are these characteristics? According to the Organisation for Economic Co-operation and Development, competition may be described as:

*A situation in a market in which firms or sellers independently strive for the patronage of buyers in order to achieve a particular business objective, e.g. profits, sales and/or market share. Competition in this context is often equated with rivalry. Competitive rivalry between firms can occur when there are two firms or many firms. This rivalry may take place in terms of price, quality, service or combinations of these and other factors which customers may value.<sup>1</sup>*

It is a fact that the South Australian retail electricity market is legally contestable; the final legal impediment to the entry of electricity retailers other than AGL SA Pty Ltd to the sub-160MWh annual electricity consumption sector of the market was removed on 1 January 2003.

What remains to be assessed by ESCOSA, therefore, is the extent to which competition between electricity retailers for patronage might develop in the South Australian retail electricity market. Put another way, how will ESCOSA best be able to assess whether competition is developing in South Australia?

The answer to this question will allow ESCOSA to establish a framework within which it will address the protection of the long term interests of South Australian consumers in respect of the price of electricity and other consumer protections in the retail market.

### **1.3 Other regulators' approaches**

Before moving to a consideration of methodologies, it is useful to note that in other jurisdictions where full retail contestability exists, regulators in equivalent positions to ESCOSA have established frameworks to assist in monitoring the development of competition. In particular, work carried out by the Office of Gas and Electricity Markets ("OFGEM") in the United Kingdom and the Essential Services Commission of Victoria ("ESCV") are of relevance. The initial work of those two bodies led to the establishment of assessment frameworks against which both have now reported.

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<sup>1</sup> Organisation for Economic Co-operation and Development, *Glossary of Industrial Organisation Economics and Competition Law*.

### **1.3.1 Why did they review the development of competition?**

While both OFGEM and the ESCV performed a similar task to that which is under consideration, they did so for different reasons.

There are a number of possible reasons for a regulator to review the development of competition. One may undertake a review of this nature to, for example, determine whether market power exists or is being exercised, or assess the appropriateness of the regulatory scheme which has been imposed on a market. As might be anticipated, these two reviews have utilised different methodologies for assessment of competition.

### **1.3.2 OFGEM review**

OFGEM has over the past several years conducted a review of domestic gas and electricity competition and supply price regulation. Of note, these reviews did not commence immediately following the introduction of full retail contestability, but rather appear to have waited for the market to settle and develop some definable and assessable characteristics. The OFGEM review culminated in the release of its Conclusions and Final Proposals in February 2002.

The retail electricity price regulation regime in place in the United Kingdom involved the setting of price caps for the former Public Electricity Supply companies. As OFGEM also has price regulation responsibilities for the gas industry, it is worth noting that relative price capping has been implemented for British Gas Trading.

The rationale for the OFGEM review was to inform OFGEM on the appropriate mechanism for future price regulation in both the gas and electricity industries. In that review, three options were identified as possible ways forward, dependent upon the findings.

- ▲ Option 1 – the extension of an absolute price control scheme for the electricity supply industry and relative price controls for the gas industry. Under this option, prices would be reset based on information submitted by affected industry participants.
- ▲ Option 2 – the alignment of price controls across the electricity supply and gas industries through the application of relative price controls. While this would maintain the status quo for the gas industry, it would represent a lightened regulatory regime for the electricity supply industry.
- ▲ Option 3 – remove of formal price controls and a shift to regulation through investigation and enforcement powers given to OFEGM under general competition laws.

The review ultimately determined that competition in the relevant United Kingdom markets had developed to such an extent that option 3 could be implemented.

### **1.3.3 ESCV review**

Under a slightly different approach, the ESCV was referred an investigation by the Victorian Minister for Energy to review whether full electricity retail competition is, or is



likely to be in the future, effective for the sale of electricity to domestic and small business customers.

This review, conducted some nine months after the establishment of the fully contestable market, found that it was simply too early to tell whether competition was developing and was only able to conclude that conditions appear right for it to develop in the future.

#### **1.4 Rationale for ESCOSA study**

Ultimately however, despite these identified differences, it can be said that the fundamental rationale behind the OFGEM and ESCV reviews and this study is the same. In each case, the regulator is undertaking an assessment of the level of competition to determine whether it is appropriate to remove price controls and let the market do its work.

While there are other uses to which information gained can be put, and these are set out in Part 3 of this paper, it is the assessment of the need for continuing price control which is the main rationale for ESCOSA's work in this area.

#### **1.5 Phased approach**

It should be noted from the outset that while this Proposed Approach paper is seeking comment on the indicators of competition which might be utilised and monitored by ESCOSA, the proposed structure has been determined.

The project is to be run in a phased manner, with the initial stage, the settling of an approach, encapsulated in this paper. Once an approach has been confirmed and appropriate indicators identified with associated mechanisms for reporting, the next step will be to gather the data associated with those indicators. ESCOSA will do this at times appropriate to the individual indicator, for example weekly, monthly or quarterly.

The results of this data collection will be published on ESCOSA's website every two months starting from the end of June 2003. To give context to that data, ESCOSA will publish analysis and commentary in relation to it on a six-monthly basis, commencing from the end of December 2003. The decision to publish analysis on a six-monthly basis has been taken to permit sufficient time for trends to become evident in the market, which bi-monthly data will not necessarily allow.

The reporting program for this project for the period to 30 June 2005 is summarised in the following table.

**Table 1 – Reporting Program for Monitoring the Development of Competition**

<b>DATE</b>	<b>NATURE OF REPORT</b>	<b>PROPOSED AVAILABILITY</b>
30 June 2003	Quantitative	Website
31 August 2003	Quantitative	Website
31 October 2003	Quantitative	Website
31 December 2003	Quantitative & Qualitative	Website and hard copy
29 February 2004	Quantitative	Website
30 April 2004	Quantitative	Website
30 June 2004	Quantitative & Qualitative	Website and hard copy
31 August 2004	Quantitative	Website
31 October 2004	Quantitative	Website
31 December 2004	Quantitative & Qualitative	Website and hard copy
29 February 2005	Quantitative	Website
30 April 2005	Quantitative	Website
30 June 2005	Quantitative & Qualitative	Website and hard copy



## 2. INDICATORS OF COMPETITION

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If ESCOSA is to monitor and assess the development of competition in the South Australian retail electricity market, it is vital that the process it uses is robust and credible. The first stage of the project must, therefore, involve consultations on identification of appropriate indicators of competition in the retail electricity market.

### 2.1 Definition of the market

The starting point for any work which intends to consider competition as a process is to identify the relevant market. Although it may be argued that this should be a relatively straightforward exercise, it is recognised that the process of market definition will contain highly subjective elements upon which different stakeholders will hold differing views.

The commonly accepted definition of a “market” in Australia was set out by the Trade Practices Tribunal in *Re Queensland Co-operative Milling Association Ltd and Defiance Holding Ltd*:

*A market is the area of close competition between firms or, putting it a little differently, the field of rivalry between them. (If there is no close competition there is of course a monopolistic market). Within the bounds of the market there is substitution – substitution between one product and another, and between one source of supply and another, in response to changing prices. So a market is the field of actual and potential transaction between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given sufficient price incentive.<sup>2</sup>*

A similar definition of the concept of a market was put forward by the Court of Justice of the European Community in *Hoffman-LaRoche AG v. EC Commission*:

*The concept of a relevant market... implies that there can be effective competition between the products which form part of it and this presupposes that there is a sufficient degree of interchangeability between all the products forming part of the same market in so far as a specific use of such products is concerned.<sup>3</sup>*

#### 2.1.1 Boundaries of the market

Both of these definitions are concerned with the concept of the boundary of the market. ESCOSA could potentially encapsulate the entire contestable market, that is to say, the market containing all possible buyers and sellers of electricity in South Australia, irrespective of issues such as consumption and willingness to offer. Alternatively, ESCOSA could limit its exploration to specific sectors only, such as the field of potential buyers and sellers of less than 160MWh of electricity annually.

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<sup>2</sup> *Re Queensland Co-operative Milling Association Ltd and Defiance Holding Ltd* (1976) 8 ALR 481 at 517.

<sup>3</sup> *Hoffman-LaRoche AG v. EC Commission* [1979] 3 CMLR 21 at 272.

There are arguments in favour of a more limited view of what the market ought to be for the purposes of assessing the development of competition. The sub 160MWh per annum market was the last tranche of customers to be made contestable and, numbering some 750,000 customers, numerically outweighs the other three tranches, who in total number only some 3,000 customers.

Nevertheless, a review of a market defined in these terms may miss the distributional impacts of the introduction of contestability in electricity retailing within South Australia. In this sense, the introduction of contestability must be seen at the broader level, with the mere fact that one is able to identify functional sub-markets within a broader context not changing the fact that there is a readily identifiable market which comprises all potential buyers and sellers of retail electricity in South Australia, irrespective of consumption levels.

Although it may be argued that there is in fact a market broader again, that is to say, a market comprising all potential buyers and sellers of retail electricity in Australia, irrespective of consumption levels, such a definition may be too broad. ESCOSA's justification for this view stems from the reality that, despite the best intentions of Governments as well as jurisdictional regulators themselves, retail electricity markets in the various jurisdictions of Australia are fundamentally different. In large measure, these differences quite rightly reflect the differing aims and aspirations of Governments in respect of consumer protections. What such differences mean, however, is that one cannot directly compare product offerings in South Australia with those in New South Wales and Victoria.

ESCOSA also notes that there is the potential for a degree of product substitution between retail electricity and gas. While it is true to say that in many instances gas can substitute for electricity, this is not always the case. In that sense, gas has been described as a "fuel of choice" in certain situations.

While there is this potential for substitution, ESCOSA does not intend to include switching between the two fuels in this study in the short-term. The retail gas market is to become effectively contestable at some point in the near future, and it would be more appropriate for ESCOSA to incorporate a consideration of substitution at that time.

ESCOSA has concluded that the most appropriate way forward for this study is to consider two broad markets; the greater than and the less than 160MWh per annum markets. The nature of these markets is sufficiently different to warrant separate consideration of the development of competition in each.

ESCOSA also recognises that the sub-160MWh per annum market is not homogenous and should be further subdivided. At the very least, ESCOSA sees a need for differentiation between residential and business customers. It is possible to break these two sub-groupings down further to look at small, medium and large business

customers, and to look at low-income residential and other residential customers in the metropolitan area and in rural and regional areas.

## **2.2 The indicators of competition**

It has been argued that competitive forces deliver greater choice and benefits to consumers. If a supplier is able to exercise significant power within its market then resources may be misallocated. Further, that supplier will have no incentive to offer any new products to consumers, and consumers may pay more for services supplied than those services are worth. Vigorous competition between suppliers can encourage them to attract more consumers through targeted service provision and/or reduced or more efficient pricing.

Competition can therefore function as an incentive to a supplier to improve business performance through service innovation and to adapt to changing market environments, leading to greater consumer choice, increased efficiencies and economic growth and, potentially, increased economic activity overall.

What then are the externally observable indicators that competition is present in a market?

Classically, perfect competition has been defined with reference to four conditions:

- ▲ There are such a large number of buyers and sellers that none can individually affect the market price.
- ▲ In the long run, resources are freely mobile such that there are no barriers to entry or exit.
- ▲ All market participants have full access to the knowledge relevant to their production and consumption desires.
- ▲ The product is homogenous.

To avoid a futile exploration for conditions of perfect competition, it is commonly accepted that it is better to determine whether any competition which might exist is workable. Although there are not commonly accepted definitive or exhaustive criteria for what might comprise workable competition, there are nevertheless some general criteria which may be considered, such as whether the number of firms in the market is at least as large as permitted by economies of scale and whether advertising and other market information is informative.

In this sense, it is often helpful to return to broader consideration of at least the first three preconditions identified as necessary for the existence of perfect competition, as these can provide a sensible and acceptable basic framework from which indicators of competition may be developed.

Further, as ESCOSA has the benefit of the opportunity to review similar work undertaken by OFGEM and the ESCV, it is also able to turn to those studies to identify other indicators of competition which might usefully be applied to the South Australian situation.

### **2.2.1 Numbers of electricity retailers**

Clearly the number of participants in a market will have an influence on the levels of competition which may exist in that market. For instance, fewer participants may lead

to lower levels of competition, particularly when there are few participants on the supply side, whereas a larger number of participants may result, in the absence of market power, in higher levels of competition.

ESCOSA does not see that it is a particularly onerous task to establish the number of participants in the South Australian retail electricity market, as it is the entity with responsibility for granting licences to retail electricity in South Australia.

ESCOSA therefore proposes to utilise data which are available to it through its ordinary reporting mechanisms monitor the numbers of participants in the market. This will be done not only in relation to the total numbers of electricity retailers who hold licences in South Australia, but will also relate to the numbers of electricity retailers who are participating in identified sub-groups within the market. For example, ESCOSA will be reporting on the number of electricity retailers who are selling or seeking to sell electricity in the:

- ▲ above 160MWh per annum market; and
- ▲ below 160MWh per annum business market, in the following sub-groups:
  - small business (0-80MWh/annum);
  - medium business (80-160MWh/annum); and
- ▲ below 160MWh per annum residential market, in the following sub-groups:
  - low-income residential, both metropolitan and rural and regional;
  - other metropolitan residential; and
  - other rural and remote residential.

ESCOSA intends to report this activity in a matrix format, demonstrating electricity retailer participation in the identified classes by overall participant numbers rather than by identifying individual electricity retailers.

***Issue 1.***

***Is ESCOSA's proposed methodology for monitoring the number of participants in the market appropriate? If not, why not, and what is an appropriate alternative?***

## **2.2.2 Degree of churn - customers**

While it is one thing to note the physical size of the market in terms of ultimate numbers of electricity retailers, it is the degree to which the patronage of buyers moves from electricity retailer to electricity retailer that may be, at least in the short to mi-term of the market, an indicator of the effectiveness of electricity retailers' rivalrous behaviours.

ESCOSA therefore proposes that any study of the development of competition must include a consideration of the level of customer churn in that market over any given time period – the trends in customer churn.

That said, ESCOSA acknowledges that the absence of switching between electricity retailers will not necessarily indicate a lack of competition in the market. For example, it may well be that the simple threat of competition spurs electricity retailers to offer better price/service mixes to their existing customers. Should this prove to be the case, then a lack of churn would not be representative of the true nature of the market. Nevertheless, the current situation in South Australia, with AGL SA as the incumbent electricity retailer holding 100 percent of the domestic and small business market as at 1 January 2003, is not one in which a lack of churn is likely to indicate better offerings by the incumbent to its current customers.

ESCOSA, as the Jurisdictional Regulator for the purposes of the National Electricity Code, is provided with regular data by NEMMCO, which administers the National Electricity Market. The data provided to ESCOSA contains details of the numbers of customers who have churned or who are in the process of churning to a new electricity retailer. It should be noted that this type of data is not available only to ESCOSA, it is also published by NEMMCO on its website.<sup>4</sup> Any data published by ESCOSA in this study will therefore be data which is already in the public domain.

In light of this, ESCOSA will undertake a review of the degree of churn in the market at specific points in time based on data provided to it by NEMMCO. However, it does not propose to treat churn numbers or trends in churn alone as the only indicators of the extent of competition within the South Australian electricity retail market.

***Issue 2.***

***Do you agree that customer churn levels will provide some, but not necessarily sufficient, indication of the existence of competition in the market?***

### **2.2.3 Electricity retailers' market share**

Closely connected with the levels of customer churn in a market is the market share held by each electricity retailer competing in the market.

As noted above, the fully contestable electricity retail market in South Australia commenced on 1 January 2003 with one electricity retailer, AGL SA, the incumbent electricity retailer, holding one hundred percent of the below 160MWh per annum market in terms of actual customer numbers. While such a figure might, in isolation, indicate a monopoly, when one considers the fact that AGL SA Pty Ltd was the only electricity retailer permitted to sell electricity to all small South Australian customers, this is not necessarily a true picture of the likely behavioural trend of the market.

Nevertheless, over time one would expect, if competition are present in the market, to see the market share of other electricity retailers rise. If this were not to be the case,

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<sup>4</sup> NEMMCO's website address is [www.nemmco.com.au](http://www.nemmco.com.au)

there may be sound arguments to say that monopolistic tendencies are a defining characteristic of this market.

There are other features of market share which require consideration though. In the electricity retail market, customer numbers alone may not be a true or accurate indicator of competition, as ultimately volume of sales may be more important to an electricity retailer. If an electricity retailer has only five customers, but those customers account for a significant proportion of the overall volume of electricity sold in South Australia, then there might well be significant competition in relation to volume, but not in relation to actual numbers of customers.

ESCOSA would therefore propose to measure not only the actual numbers of customers that each electricity retailer has over given periods of time, but at the same time to analyse those number in terms of the actual volume of electricity sold in the South Australian retail electricity market. The effect of monitoring such matters over time provides the ability for ESCOSA to report not only on “snapshots” of the market, but also on trends which develop within the market over reporting periods.

This data is available to ESCOSA through its regular reporting requirements imposed under the licence conditions of electricity retailers. ESCOSA already publishes volume data through its annual performance reporting series and intends to utilise the same data sets for the purposes of monitoring the development of competition.

**Issue 3.**

***To what extent are the number of customers and the volume of overall sales each electricity retailer has over a given period of time indicators of the development of competition?***

#### **2.2.4 Barriers to entry**

A barrier to entry into a market is, in essence, anything impeding the entry of new competitors into a market. For example, the mere fact that under the *Electricity Act 1996* a business may not retail electricity to South Australian customers without first being granted a licence to do so by ESCOSA might itself be seen as a considerable barrier to entry.

A more comprehensive consideration of the concept of a barrier to entry however is that a barrier to entry is a factor which prevents or deters the entry of new competitors into a market even when incumbents within that market are earning excess profits. Under such an expanded definition, a barrier to entry might fall into one of two classes; structural (or innocent) and strategic.

Structural barriers to entry are those which can be seen to stem from basic characteristics of the market in question, such as technology, costs and demand.

The widest definition would suggest that these barriers to entry arise from factors such as product differentiation, the absolute cost advantages enjoyed by market incumbents and economies of scale.

- ▲ Product differentiation is an advantage for incumbents since entrants are required to overcome such matters as accumulated brand loyalty as a part of the market entry process if they are to take any profits from the market.
- ▲ The absolute cost advantages enjoyed by incumbents imply that a new entrant will generally be faced with higher unit costs at every rate of output. This may be attributable to inferior technologies or, perhaps more likely, a lack of knowledge of practical applications of production processes in the particular market.
- ▲ Economies of scale will act as a barrier in the sense that in practice there will be a restriction on the number of suppliers who are able to operate at minimum costs in a market of a given size.

A more narrow definition would suggest that barriers arise only when entrants must incur costs not borne by incumbents, and does not incorporate any reference to economies of scale.

A strategic barrier to entry on the other hand arises from the behaviours of incumbents within a given market. Of particular note, incumbents may have an incentive to heighten structural barriers or threaten to retaliate against entrants if they do enter.

Given these definitions, ESCOSA has formed an initial view that at least the following broad categories of barrier need to be considered:

- ▲ The regulatory framework surrounding the retail electricity market in South Australia, including Acts of Parliament as well as ESCOSA's licensing requirements and regulatory instruments;
- ▲ The practical operations of the retail electricity market in South Australia given the operational strictures imposed by the requirements of the National Electricity Market.

Barriers to entry, and their existence or effect, are difficult to identify in the abstract. One practical mechanism which ESCOSA proposes to utilise to assess the occurrence or impact of any barriers to entry will be to survey existing electricity retailers operating in the South Australian market and, where possible, electricity retailers operating interstate who have not yet entered the South Australian market. While this data may not be particularly useful in identifying any single barrier which might preclude a new entrant, it is nevertheless likely to identify combinations of barriers which could lead to this result.

***Issue 4.***

***Are there any other barriers to entry which ought to be considered by ESCOSA in a study? Are there any other methods which ESCOSA could use to assess the incidence and impact of barriers to entry?***

## 2.2.5 Information asymmetries

As noted above, the provision of information in a market is crucial to the effective operations of the market. Where there is not a balanced sharing of information, for example where a supplier knows more about the product in the market than does the buyer, this situation is often described as one of information asymmetry.

When considering the position of South Australian customers in the electricity retail market, it is reasonable to assume that the information which they possess about such matters as their needs for a retail electricity service, or the type and quality of that service, or the adequacy of the service rendered, or whether that service was excessive or inadequate for their needs, or even the competent versus the incompetent supplier, will be less than the information possessed by electricity retailers in respect of those same issues.

The problem of information asymmetries is particularly relevant in a service sector like the electricity retail market since these sorts of factors can generally only be assessed after a service has been provided, by which time damage or loss may already have been suffered.

So if conditions of competition necessarily require the non-existence of significantly differing levels of information about a product, then it would appear to ESCOSA that monitoring levels of customer understanding of retail electricity offerings is a necessary element of the proposed study.

The approach adopted by the ESCV in this regard has appeal to ESCOSA. The ESCV in its study monitored the following items:

- ▲ Customer awareness of the ability to switch electricity retailer;
- ▲ The ease of obtaining and comparing information about retail electricity contracts;
- ▲ The extent and nature of marketing behaviours in the market;
- ▲ The extent and nature of offers being made;
- ▲ Any evidence of misleading or deceptive behaviour.

ESCOSA would propose to use a similar set of items in assessing the degree of information imbalances within the South Australian market. Such information will need to be gained through market surveys of both customers and electricity retailers on a regular basis. A further source of information would be the monitoring of the existence and output of third party information intermediaries in the retail electricity market. ESCOSA notes that the establishment of such bodies and the publication of information by them may itself be a sign of developing competition in a secondary market.

### ***Issue 5.***

***Is the proposed approach of ESCOSA in relation to monitoring information asymmetry appropriate for the South Australian retail electricity market?***

### **2.2.6 Price/service mix**

A further indicator that competition is doing its work will be an assessment of the price/quality mix being offered in the market.

Although many customers may understandably be interested only in the price element of this mix, ESCOSA does not see that this factor alone is of great assistance. For example, should an electricity retailer offer a better price but only at a lower level of service, then it is possible that the reduction in service might actually outweigh the reduction in price. Should this prove to be the case, then in overall terms a customer may be worse-off than had they not taken that offer.

Of course, the above example is perhaps extreme, but does demonstrate the potential difficulties in focussing solely on price.

One problem that ESCOSA can foresee in respect of this indicator is that, unlike other indicators discussed above, it may not be able to readily access details of market offerings made by electricity retailers. ESCOSA therefore proposes that market surveys be undertaken to obtain a view on the nature of offerings which are being made to the market from time to time in the sub-groups identified in section 2.2.1. By tracking changes in these offerings, ESCOSA will be able to build a picture of how the price/service mix is or is not evolving.

***Issue 6.***

***Do you agree with ESCOSA's proposed approach to the monitoring of the price/service mix in the retail electricity market? Are there any other price related issues which ESCOSA ought to consider?***

### **2.2.7 Extent of market offerings to low-income customers**

A key indicator which ESCOSA will look to for evidence that there is competition in the South Australian retail electricity market is the extent to which electricity retailers are making market offers to low-income customers. In ESCOSA's view, if this segment of the market is ignored and those customers are not able to access competitive offerings, then it will not be possible to conclude that there is effective retail electricity competition in this State.

As outlined in section 2.2.1, ESCOSA will be actively monitoring the numbers of electricity retailers who are competing in a number of categories, one of which is low-income customers in both metropolitan and rural and regional areas.

ESCOSA has already indicated the importance of this particular market segment through its ongoing research into the impacts that fuel (gas and electricity) prices have in driving levels of financial hardship in South Australia. Data obtained from that study will assist in identifying particular subsets within the low-income category which may

require specific interventions should it be demonstrated that electricity retailers are “cherry-picking” the market and not making offers to these customers.

## **2.2.8 Innovation in product offerings**

As has been noted previously, one of the intended benefits of the introduction of competition to the retail electricity market was to unleash the potential for electricity retailers to offer innovative products into the market.

It is sometimes difficult for ordinary consumers to see exactly how the sale of electricity could be improved as a result of the coming of full retail contestability. This is particularly so when it is the electricity distributor, rather than electricity retailers, who bears the responsibility for the quality of electricity, which is often taken to be the sole measure of service in the electricity supply industry.

Nevertheless, ESCOSA is of the view that there is a great deal of potential for innovation in the retail electricity market, ranging from billing and payment options all the way through to the bundling of services. That said, it is timely to note that should innovations occur at that far end of the scale, there will need to be significant consideration given by regulators to ensure that all the potential benefits of a bundled service can flow through to the consumer.

One of the problems faced by ESCOSA in this area is ascertaining precisely the nature of the products which electricity retailers are offering in the market.

Through the Electricity Retail Code, ESCOSA has taken the deliberate step of not requiring electricity retailers to seek approval for the terms and conditions of market contracts. Instead, subject to electricity retailers’ compliance with certain mandatory provisions of the Electricity Retail Code, they are free to use whatever contractual provisions they wish.

While ESCOSA hopes this provides freedom and encourages innovation, at the same time it removes its ability to understand exactly what it is that electricity retailers are offering. As a result, ESCOSA will need to undertake some form of market observation to gain information which would indicate trends towards innovation. This could take the form of electricity retailers voluntarily offering information on a confidential basis, or, alternatively, ESCOSA could engage in market analysis itself.

On a cautionary note, ESCOSA considers that aside from billing and payment plans, it is possible that the potential for innovation will not really arise until such time as there is effective contestability in the South Australian retail gas market, anticipated some time in the coming year. When this occurs, it would be expected that retailers who are able to tap into the economies of scale and scope that a dual fuel offering entails ought to be able to pass benefits on to South Australians through innovative product offerings.

**Issue 7.**

***Do you agree that innovation in product offerings by electricity retailers is a useful indicator of competition? How might it be measured?***

**2.2.9 Any other indicators?**

ESCOSA notes that the matters outlined above may not comprise the entire set of indicators which will best serve to identify the existence or extent of competition in the South Australian fully contestable electricity retail market.

ESCOSA would therefore be pleased to receive comment from interested stakeholders on other indicators which might be adopted as a part of the proposed study.

**Issue 8.**

***Are there any other indicators which ESCOSA ought to consider when assessing the development of electricity retail competition?***

**2.3 Summary**

The following table sets out in summary form the categories and indicators which ESCOSA intends to use in its study, and the proposed source of this information.

**Table 2 - Summary of indicators of competition**

<b>CATEGORY</b>	<b>INDICATOR</b>	<b>SOURCE</b>
<b>Numbers of electricity retailers</b>	Actual numbers	ESCOSA
	Participating in above 160MWh per annum market	ESCOSA Guideline 2 Reporting
	Participating in below 160MWh per annum business market (small and medium)	ESCOSA Guideline 2 Reporting & ESCOSA survey of electricity retailers
	Participating in below 160MWh per annum residential market (low-income and other, metropolitan/rural and remote)	ESCOSA Guideline 2 Reporting & ESCOSA survey of electricity retailers
<b>Degree of customer churn</b>	Numbers of customers changing electricity retailer over a given time period	NEMMCO
<b>Electricity retailer market share</b>	Trends in customer numbers and electricity volumes over time	ESCOSA Guideline 2 Reporting
<b>Barriers to entry</b>	The existence of any barriers to entry which either are or might impede new entrant electricity retailers	ESCOSA survey of electricity retailers licensed in SA and interstate electricity retailers not currently licensed.

<b>CATEGORY</b>	<b>INDICATOR</b>	<b>SOURCE</b>
<b>Information asymmetries</b>	Customer awareness of ability to switch	ESCOSA survey of customers
	Ease of obtaining information	ESCOSA survey of customers
	Extent and nature of marketing behaviour	ESCOSA market survey
<b>Price/Service mix</b>	Extent and nature of offers	ESCOSA market survey
<b>Impacts on low-income groups</b>	Evidence that low-income groups are experiencing competitive offerings	ESCOSA survey of customers and electricity retailers
<b>Innovation</b>	Evidence of innovative product offerings	ESCOSA market survey

### 3. USES OF INFORMATION GAINED

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Although it is too early, and potentially limiting, to try to identify all possible uses to which information gathered through a study of this nature could be put, ESCOSA has, at a preliminary level, identified four potential uses for an assessment of electricity retail competition:

- ▲ To inform the ESCOSA's approach to price setting in the market, with reference in particular to Guideline 10 "*Electricity Retail Price Justification*" and the application of chapter 3 of that Guideline.
- ▲ To inform a review under section 28(8) of the *Essential Services Commission Act 2002* of the overall effectiveness of ESCOSA Codes and Guidelines applying to the electricity supply industry.
- ▲ To assess the quantum and distribution of the costs and benefits flowing from the implementation of full electricity retail competition in South Australia.
- ▲ To inform the public, who have a right to know, how competition is developing, how it has impacted on consumers and how they can take part in the market themselves.

#### **3.1 Continuation of price setting for standing offers and default contracts**

In September 2002 the South Australian Parliament amended the *Electricity Act 1996* to take effect from 1 January 2003 by inserting a number of new measures aimed at providing consumer protection for South Australian electricity consumers.

One of the key amendments was the introduction of retail pricing controls for the class of consumer defined as small customers. Under the amendments, an electricity retailer declared by the Governor, at this stage AGL SA Pty Ltd, is required to offer to sell electricity on standard terms and conditions and at a standard price to any South Australian customer using less than 160 MWh of electricity annually. This obligation is known as the obligation to have a "standing offer".

The standard price which is offered to these small customers is one which must be "justified". This means that the electricity retailer is required to publish the price in combination with a statement setting out why that particular price is appropriate for the sale of electricity. If the Minister determines, ESCOSA can have a role in this process to review the justification statement and the published price to ensure that there is an independent view formed as to the appropriateness of the price.

If ESCOSA forms the view that the price is justifiable in the context of the South Australian market, it may permit the price as published to remain in force. If it is not convinced, then it has a power to substitute the published price with a price that it determines to be justified. In the case where this occurs, the price determined by ESCOSA will thereafter be the price at which the electricity retailer must sell electricity to its small customers under its standing offer.

It should also be noted that a similar process has been put into place by the South Australian Government for "default contracts". A default contract is a legal relationship which is deemed

to come into effect where a customer uses electricity at a premises without entering into any arrangements with an electricity retailer to buy electricity for consumption at that premises. In these situations, a relationship is deemed to exist with the effect that the electricity retailer who was last in a retail electricity contract with a customer in relation to the premises is considered to have entered into a retail electricity contract with the new user, even though the identity of that user may be unknown to the electricity retailer.

The purpose of these default contract arrangements is twofold. It permits the customer who, through a lack of knowledge or otherwise, fails to enter into either a market-based contract or a standard retail electricity contract to purchase electricity subject to a minimum set of standard consumer protection terms and conditions. It also permits an electricity retailer to recover its costs under a contract, rather than having to pursue a potentially unknown customer through legal processes.

Every electricity retailer who sells electricity to a small customer in South Australia is required to publish and justify a default sale price. As in the case of the standing offer price discussed above, ESCOSA can consider that price and, if necessary, substitute a price it views as justified.

Given the obligation to justify these prices exists without any express legislative guidance as to how precisely to satisfy the obligation, ESCOSA determined in 2002 that it would be appropriate to provide some guidance to electricity retailers on what it considers a justified price might look like. This was done through its Initial Thoughts paper *“Reviewing and Approving Electricity Retail Prices in a Competitive Market”*, released in early 2002.

ESCOSA’s final views have been expressed through Guideline 10 *“Electricity Retail Price Justification”*. The matters outlined in the Guideline were based on ESCOSA’s understanding of the electricity market as it existed during 2002, as well as its forward projections of the way that the market might look in 2003.

The reality of the market in 2003 and going forward was, necessarily, a matter of some forecasting and conjecture. The conditions which ESCOSA considered might arise may or may not come to pass. One key determinant of the way in which a retail electricity price might be justified or otherwise could be the extent to which the retail electricity market comes to display the hallmarks of a truly competitive market. At the time that the Guideline was drafted, certain assumptions about the level of competition were made. Should these assumptions not be borne out by practical experience, then arguably the riskiness of being required to offer to sell electricity, and therefore the quantum of the price offered, will change.

One potential purpose to which any ESCOSA assessment of the development of competition might be put, therefore, is to inform ESCOSA as to whether it is appropriate to continue to set retail electricity prices for standing offers and default contracts and, if it is considered appropriate, the best method to adopt in doing so. Alternatively, if the evidence indicates that competition is strong and the risk of market abuse is low, ESCOSA would be inclined to withdraw from price fixing activities and adopt less intrusive methods protecting consumers.

### **3.2 Overall effectiveness of ESCOSA Codes and Guidelines**

In the period leading up to the commencement of full retail contestability on 1 January 2003, ESCOSA undertook a comprehensive review of its industry codes under section 28 of the *Essential Services Commission Act 2002*.

The results of this review were the making of new industry codes. The former *Retail Code* was replaced by a reasonably similar *Electricity Retail Code*, the former *Distribution Code* was replaced by a substantially similar *Electricity Distribution Code*, while the former *Metering Code* was replaced by an entirely new *Electricity Metering Code*. At the same time, ESCOSA made two new industry codes to apply to the electricity supply industry, the *Electricity Marketing Code* and the *Electricity Consumer Transfer and Consent Code*.

A number of assumptions concerning the nature of the retail electricity market going forward were required to be made by ESCOSA in developing these new industry codes. Given the accuracy of these assumptions, the practical effectiveness of the industry codes in achieving their desired ends may or may not be met.

Again, a key assumption underpinning many of the policy decisions taken at the time the new industry codes were being developed during 2002 was the level of competition which might exist in the early stages of the fully contestable market.

One of the concerns which ESCOSA has, and which is demonstrably shared by the electricity supply industry itself, not only in South Australia but Australia-wide, is that the regulatory instruments it might put into effect, such as the industry codes, may act as a barrier to competition either by deterring new entrants or through stifling the potential for innovation. As is recognised in clause 5 of the Competition Principles Agreement, the potential exists for any regulatory instrument to be miscast, and impede, rather than assist, in the orderly delivery of the benefits which markets are generally assumed to bring.

In light of this, any framework adopted by ESCOSA to assess and monitor competition in the South Australian retail electricity market could, if correctly targeted, assist ESCOSA in evaluating whether its industry codes remain appropriate and are not hindering the development of higher levels of competition between electricity retailers.

### **3.3 Quantum and distribution of costs and benefits**

The introduction of full contestability to the retail electricity market was a policy decision implemented by successive South Australian Governments. Underpinning this policy decision is a view that it is the process of competition, rather than regulation, which can, ultimately, deliver maximum benefits to consumers through lower prices, better goods and services and increased efficiency. Competition, it is argued, provides these outcomes in a more expeditious and efficient manner than does direct intervention into a market by a Government.

What have historically been ignored, however, by many who advocate the implementation of competition are the distributional, rather than aggregate, impacts that a move to a competitive market might have for the community.



Many of the arguments put forward in favour of competition are couched in terms of benefits which accrue to the community as a whole. Implicit in statements such as these is the recognition that some sectors of the community may be worse off while at the same time others will be made better off, leading to an aggregate benefit, following the introduction of competition to a particular market.

While ESCOSA does not quibble with the view that in a fully or reasonably competitive market the competitive processes may bring benefits, it remains to be convinced that in practice the retail electricity market will display sufficiently competitive characteristics to ensure that all members of the community obtain benefit.<sup>5</sup>

Therefore, although not advocating intervention into a market as a general rule, a process of assessing the development of competition will allow ESCOSA to form views on the distributional impacts of competition and consider the most appropriate means of response to rectify market failures or deficiencies or to provide basic protection to those impacted negatively by the market.

One example of an area in which ESCOSA believes that monitoring the development of retail electricity market competition is required is fuel driven hardship. Through the course of 2002, ESCOSA commenced research into the existence, incidence and broad impact of fuel driven hardship on the South Australian community. If, as has been promised, full retail electricity contestability leads to the development of competition, then the benefits of that competition ought to be reflected in the outcomes of the ESCOSA research over time.

### **3.4 Informing consumers**

Perhaps the most important and valuable use of information regarding the development of competition in the South Australian retail electricity market is to keep South Australian consumers informed.

It is often said of markets that there are high levels of information asymmetry, or imbalance, as entities like electricity retailers know much more about the market's operations than do consumers. Where this is the case, the lack of knowledge on the part of consumers can lead to them being unable to make clear and informed purchasing decisions. On this view, therefore, keeping consumers informed on competition issues can only be of assistance.

At another level however, ESCOSA regards the provision of this type of information to consumers to be an obligation placed on it. Aside from economic arguments about information imbalances, ESCOSA believes that as the regulator for essential services in this State, it is incumbent upon it to ensure that South Australians have the ability to actively participate in the retail electricity market, and are not simply relegated to a role of passive participants. The provision of information such as that which is proposed to be collected in

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<sup>5</sup> This phenomenon in relation to the introduction of full retail contestability in Australia was recently discussed by Conor Wynn in an article *Deregulated electricity a flop for all but a few*, Australian Financial Review, 17 February 2002 at 71.

this study should go some way towards fulfilling that function. After all, competition from the supply side of the market requires active participation from consumers.

Therefore, as outlined in section 1 of this paper, a significant part of this study will be the public dissemination of information by ESCOSA on a regular basis.



## **4. NEXT STEPS**

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The purpose of this Proposed Approach paper is to set out ESCOSA's thoughts on the development of an appropriate methodology for assessing the existence and level of competition in the South Australian retail electricity market.

The paper is not intended to be an exhaustive or definitive work, but rather aims to stimulate discussion and debate about the commencement of the fully contestable market.

ESCOSA therefore welcomes all comments on the matters set out in this paper, as well as any matter which respondents consider ought to form part of the study.

Following the close of submissions on this paper, ESCOSA will prepare a Position Paper setting out its detailed framework for assessment of competition.

ESCOSA would propose that this final framework will be put in place before the middle of 2003. This would allow a limited time for market systems to be bedded down and for electricity retailer activities in this State to have commenced in earnest. Within that period, ESCOSA will collect and maintain base level data on the market in order to report in compliance with the reporting timetable set out in table 1 of this paper.