

Mr Gary Banks
Chairman
NCP Inquiry
Productivity Commission
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Dear Mr Banks

Productivity Commission Review of National Competition Policy Reforms – Discussion Draft

The Energy Retailers Association of Australia (ERAA) is pleased to comment on energy related matters arising out of the Discussion Draft (the Report) released by the Productivity Commission (the Commission). The ERAA welcomes the opportunity to participate in the Commission's inquiry and contribute to further increasing the efficiency of the retail energy market in Australia.

The ERAA believes that significant progress has been made on energy market reform through the Ministerial Council on Energy's (MCE) energy market reform program, particularly in the large non-regulated customer markets where price reductions and efficiency improvements have contributed to efficiency gains for Australian industry.

In our submission to the Issues Paper on this review we expressed the view that there is still work to be done on energy market reform. We believe that there is opportunity to focus the reforms to areas that will contribute most to increasing the efficiency and competition in the energy market.

The ERAA previously identified the following issues that needed to be addressed by the MCE to increase the effectiveness of competition in the retail energy market:

- Extension of full retail contestability;
- Appropriate institutional and governance arrangements;
- An efficient and consistent national regulatory and market framework; and
- Phasing out of retail price regulation.

The ERAA considered that effective resolution of these issues will ensure that:

- Benefits of competition are fully realised across all retail energy markets and that customers are protected through robust competition; and
- Appropriate incentives are in place to achieve investment in demand and supply side initiatives to ensure security and reliability on energy supply and to meet the environmental goals in an efficient manner.

Proposals for national reform agenda

The ERAA notes the Commission's draft proposals for a national reform agenda for energy (page 175 of the Discussion Draft) state that governments should complete all outstanding National Competition Policy (NCP) reforms and implement the identified areas of priority for the MCE.

The ERAA notes the Commission's draft proposals that the MCE should give priority to:

- Contributing to the development by CoAG of a more effective process for achieving a national approach to greenhouse gas abatement. We believe that a national and economy-wide approach that has a long-term focus is critical to ensure an efficient greenhouse response, and to ensure the regulatory certainty necessary for the significant infrastructure investment required, especially in new generation capacity;
- Assessing whether processes for screening the competition implications of any reintegration in the electricity industry need strengthening. The ERAA does not believe that compelling reasons have been put forward to justify the need for special merger rules for electricity or the need for further consultation on this matter. We therefore do not support this proposal. We agree with the Commission that a "knee jerk" response could discourage investment in industry and reduce scope for market structures to evolve efficiently over time in response to changing circumstances;
- Establishing a process for the independent monitoring of the implementation and outcomes of the energy reform program and a stocktake of progress in 2009. The ERAA supports this proposal.

The ERAA, is however concerned that the Discussion Draft does not make any specific recommendations with respect to gaps in fully implementing competition in the retail sector even though the benefits of competition¹ and some of the gaps are discussed in the report. The ERAA believes that despite a decade of energy market reforms significant further work is still required to realise the full benefits of competition reforms in the Australian energy market. We believe that energy market reform requires a renewed commitment from all stakeholders to address the outstanding issues, and to ensure that the current trends do not unwind reforms undertaken to date.

¹ The role of competitive markets in encouraging efficient resource use and promoting community well being more generally has long been recognised. Competitive markets usually deliver good outcomes because they act to align the interests of consumers and suppliers. That is, in seeking to maximise profits, suppliers have strong financial incentives to produce at the lowest cost, to provide the mix and quality of goods and services required by consumers and to innovate in order to achieve competitive edge" [Discussion Draft Box 2.1, page 10].

We reiterate the retail energy market issues identified in our response to the Issues Paper. We are of a strong view that:

- There must be an increased emphasis on implementation of full retail contestability to realise the potential economy-wide benefits and to ensuring competitive neutrality in the market;
- To ensure markets are allowed to work to achieve efficient outcomes the energy market should only be regulated where there is a demonstrated market failure:
 - Transitional retail price path regulation in markets that are competitive should lapse at the end of the current regulatory periods;
 - Customer protection regulation should only be required where there is a demonstrated market failure, be targeted to those who need protection, and be based on clear regulatory objectives and principles of best practice regulation; and
- The regulatory framework should be supported by appropriate institutional and governance arrangements.

Full contestability in retail energy markets

While the Discussion Draft recognises the role of competitive markets, it has not addressed the failure in some jurisdictions to complete energy market reforms (who have chosen instead to rely heavily on prescriptive regulation) and of others to implement full retail contestability in their jurisdictions. There may be a number of reasons for this failure to implement full retail contestability, including concern for the expected distributional impacts (on pricing in particular) on small customers as cross subsidies are unwound.

The Discussion Draft recognises that there will be transitional and distributional impacts² from NCP reforms. However, consistent with the Commission's assessment, these impacts should not be a reason to delay or forego reforms or distort the operation of competitive markets through regulatory intervention. Instead the focus must be on identifying and addressing demonstrable market failure and on addressing the transitional and distributional impacts of the NCP in a transparent manner.

The Discussion Draft (page 84) notes that governments have adopted a commonly agreed definition of CSOs and have accepted the principle that the costs of CSOs should be transparent and funded directly through consolidated revenue. The ERAA believes that the transitional and distributional impacts of NCP reforms should be funded by governments through community service obligations (CSOs).

The Network Tariff Rebate in Victoria is one example where a transitional impact of NCP has been effectively addressed without distorting the operation of a competitive market.

² It is inevitable that reforms designed to remove sources of inefficiency in the economy will create some "losers" as well as "winners". For example NCP has led to job losses and reduced incomes in some regional communities, though it is apparent that other regional centres have often gained from reforms. The costs experienced by some individuals or communities are not sufficient reason to forego reforms that are of substantial net benefit to the community as a whole. However, it is important to ensure that the implementation of reform takes accounts of any significant transitional and distributional impacts" [Discussion Draft, Key points, page 79].

It is also important that the implementation of NCP reforms is not distracted by the direct impacts of NCP only, but also recognises the indirect and economy-wide benefits of reforms. The discussion draft notes that the direct impacts, such as the potential increase to energy prices as cross subsidies are unwound to make prices more cost-reflective, can be offset by the indirect benefits³.

It is important to achieve a renewed commitment to NCP reforms and a timetable for the introduction of full retail contestability and unwinding of regulation.

The ERAA believes that where a cost benefit analysis encompassing direct and indirect benefits on an economy-wide basis, identifies a net benefit from the introduction of full retail contestability, markets should be fully opened up to competition (and deregulated) to ensure that the full benefits can be realised by customers.

The ERAA also believes that the costs and benefits of extending competition to other services in the retail energy market should be further investigated. As a principle, regulatory and government decisions should not impede the development of a competitive market in such services.

Some jurisdictional governments have implemented arrangements to manage wholesale risk in the energy markets and the relevant regulators have included these arrangements in their retail pricing decisions. As a consequence, the resulting regulated prices underestimate the true risks and costs of supply. The failure of regulated prices to reflect all the risks faced by all retailers in the retail energy market has resulted in issues of competitive neutrality and has the potential to impact on investment.

The ERAA believes that it is important that a level playing field is provided for all market participants based on principles of competitive neutrality to promote investment in generation, encourage new entrants into the retail sector, and to encourage demand management and energy efficiency. Strong and nationally consistent ring-fencing obligations between all network operators and retailers is also an imperative.

Energy market regulation only in the cases of demonstrable market failure

At the commencement of full retail contestability, arrangements were put in place to ensure that customers were protected from potentially irresponsible marketing/customer service from some retailers. There was a clear intention expressed by regulators at the time that these arrangements should be less prescriptive and that they would be transitory in nature.

However, in recent times there appears to be a move away from this objective with a tendency to legitimise heavy-handed customer protection regulation and price regulation despite the retail energy market being opened to competition and despite the recognition that competitive markets need relatively little regulation to function effectively⁴.

³ Although dated, an Industry Commission Report noted by the Commission report estimated, that whilst households in the lowest income group on average would spend an extra \$17 on electricity, they theoretically may have saved on average \$40 per year on their indirect consumption of electricity – that is electricity costs embodied in the prices of other goods and services [Discussion Draft, Box 5.1 page 83].

⁴ Competitive markets often need relatively little regulation to function effectively – relying on prices to convey information about supply and demand, and thereby condition the behaviour of consumers and producers. Importantly, while well functioning competitive markets require defined and enforceable property rights, they do not depend on large number of firms. Where

The reviews into effectiveness of competition carried out recently in some jurisdictions, instead of identifying market failure and promoting measures to address identified market failure, have focused on whether or not competition is effective based on highly subjective and arbitrary measures.

The regulation of the retail energy market is driven by the potential for market failure, based on anecdotal evidence of risk, which has never been demonstrated. Further there is a lack of an objective assessment of such issues, leading to unnecessary, intrusive and costly retail energy market regulation. Existing regulation applies broadly and is not targeted to specific risk. To ensure regulation is cost efficient, it should be designed to meet the objective of protecting the target customers, such as those in genuine hardship, and should not apply to all customers.

In recent times some sectors have promoted that regulators increase level and extent of regulation and to delay the unwinding of regulation. This occurred despite the independent regulators' objective assessments (following full public consultations) that the market is ready for a reduction in the level of regulation in the retail energy market. There also have been instances where governments have legislated to overrule the independent regulators' decisions without consultation or proper regulatory impact assessments.

The jurisdiction-based and fragmented approach to energy market regulation, has been without clearly articulated regulatory objectives. In some cases the lack of objective assessment and consultation has led to a proliferation of regulation, duplication (both jurisdictional and in instruments) and inefficiencies in the regulation of the retail energy market. We believe that the lack of separation of powers between the rule-maker and the enforcement and compliance agency in some jurisdictions may also have contributed to inefficient regulation.

The ERAA believes that it is imperative that:

- The NCP reforms in the energy market are based on the principle that energy market should only be regulated where there is a demonstrable market failure; and
- There is a total commitment from all stakeholders to implementing an efficient and consistent national regulatory framework.

It is important that these principles are recognised in the Commission's final report.

Our concerns about retail price regulation and consumer protection regulation are dealt with in more detail below.

Retail price regulation

The ERAA welcomes the recognition by the Commission⁵ that:

there are only a small number of suppliers, the threat of being undercut by new entrants to the market if prices are too high or quality is poor will often ensure that the needs of consumers are met efficiently and effectively.....Unlike competitive markets, administered market arrangements often fail to provide strong incentives for efficiency, to respond to changes in customer needs and facilitate innovation." [Discussion Draft, Box 2.1 p. 10]

⁵ Discussion Draft, page 174.

- it is particularly important that prices efficiently signal the need for consumers to adjust their consumption patterns in response to changing supply conditions and the need for producers to invest in new capacity;
- if regulated prices are unduly suppressed, the longer term sustainability of supply could be compromised; and
- ensuring low income users have adequate access to power and other services is best handled through transparent community service obligation payments, rather than through the general suppression of prices.

The Discussion Draft suggests the MCE could play a useful role in exploring ways to improve the efficiency of retail price regulation with a particular emphasis on facilitating the responsiveness of both demand and supply to changing market conditions.

The ERAA does not accept that price regulation remains a legitimate and ongoing role for governments to facilitate consumer protection goals a full decade after NCP reforms began and after some 3-4 years of full retail contestability. It will be some 5-6 years by the time the current retail price paths expire.

The presumption that the retail energy market will not be effectively competitive, is an admission that competition reforms in the retail sector will have failed. This does not appear to be backed up by any evidence of market failure in jurisdictions where competition has been introduced.

We urge the Commission to establish a timetable for the jurisdictions to review the effectiveness of retail competition, in the context of identifying and addressing market failure, as a priority - with the objective of removing retail price regulation when the current price paths expire. The ERAA does not support the transfer of retail pricing to the national regulator. Further, priority should also be given to identifying and addressing transitional and distributional impacts of NCP in a targeted and transparent manner as discussed above.

The ERAA believes that based on an accepted premise that effective competition is the ultimate goal, price regulation is a key impediment to effective competition. For a market to be effectively competitive, prices must be determined by competitive market forces.

Whilst retail price controls remain, efficient market outcomes will be distorted and effective competition inhibited. Prices should reflect costs to promote investment in generation and retail supply and to promote demand management and energy efficiency. Lack of cost-reflective retail prices has unintended consequences such as reducing the incentives for demand management and energy efficiency (as noted by Parer) and unchecked increases to peak energy demand (eg. current summer demand levels). This results in a need for costly investment that would otherwise not be required, resulting in increased costs to all customers. Price controls inhibit innovation, and thus frustrate the objectives that governments are seeking from demand side response.

The sooner market competition sets customer prices - and not a regulator – the sooner more efficient outcomes will be realised.

The ERAA recognises that governments may wish to pursue social equity and/or affordability issues. To the extent that governments identify these issues, they should be

addressed not through price controls which inhibit competition, but through direct and transparent government payments (as noted above).

While artificially low regulated tariffs remain attractive alternatives to market contracts, competition from retailers will continue to be stifled. The ERAA is strongly of the view that regulated tariffs should transition to cost-reflective levels quickly and then, ultimately be removed. Governments may continue to monitor prices and take action under competition law or alternatively maintain reserve powers under jurisdictional regulations.

As a transitory measure towards the removal of price regulation, The ERAA welcomes the moves, made in most jurisdictions where full retail contestability has been introduced, towards a light-handed form of regulation of retail prices for residential and small business customers, for example, the price paths agreed for Victoria and NSW gas. At the conclusion of these price paths (after 5 to 6 years of full retail contestability), the ERAA expects that the retail energy market will have strong competition and considers that jurisdictions should not continue with price regulation.

Consumer protection regulation

The complexity of consumer protection arrangements and differences in regulatory requirements across jurisdictions impose significant compliance costs upon retailers which in turn diminish the benefits that would otherwise flow from energy market reform.

In addition to the direct costs of regulation, inappropriate regulation can add substantial indirect costs through distorting and delaying the benefits of competition being realised, or add to externalities through inefficiency.

The ERAA agrees with the Commission's view⁶ that while consumer protection regulation has a potentially important role in facilitating the efficient functioning of markets [*especially where there is demonstrable market failure*], it is not without costs, including that:

- poorly designed regulation can stifle efficient market competition, investment and innovation and thereby be detrimental to the longer term interests of consumers;
- though products standards that reduce the range of market offerings may ease the “burden of choice” for some consumers, for others, they may represent an unwanted constraint on purchasing decisions;
- regulatory compliance and enforcement costs can often be significant.

The ERAA also agrees with the Commission that “it is important not to overstate the extent of the problems that arise from the informational market failures that underpin consumer protection regulation” and that the “upshot is that the need for standards and other forms of consumer protection regulation must be considered on a case by case basis, having regard to

⁶ Discussion Draft, Box 9.3, page 217

both the significance of the problems for consumers and hence the likely benefits of addressing them, and the costs of doing so⁷.”

Historically, the consumer protection provisions have been drafted with a small group of customers in mind (such as those in genuine hardship), but have been applied to all customers, unnecessarily increasing the costs and complexity of regulation.

The Commission notes that a range of systemic shortcomings in Australia’s standards and other consumer protection regimes were drawn to its attention including⁸:

- ineffective mechanisms for coordinating the activities of the plethora of Australian Government and State and Territory bodies involved in policy development and application leading to:
- duplication of effort; and
- inconsistencies in approaches across jurisdictions that increase compliance costs and impede the development of national markets;
- insufficient information given to the scope for self-regulatory and co-regulatory approaches and
- tensions between the administrative role of consumer affairs bodies and their commonly adopted role as advocates for consumers.

The ERAA supports the Commission’s proposal⁹ that there should be a national review into consumer protection policy and administration in Australia, focusing on:

- the effectiveness of existing measures in protecting consumers in the more competitive market environment;
- mechanisms for coordinating policy development and application across jurisdictions and for avoiding regulatory duplication;
- the scope for self-regulatory and co-regulatory approaches; and
- ways to resolve any tensions between the administrative and advocacy roles of consumer affairs bodies.

Energy market regulation should only be considered where there is demonstrable market failure.

The MCE’s work on a national regulatory framework for energy (with respect to consumer protection) must be consistent with the Commission’s proposed national review. In considering the national regulatory framework for consumer protection, it is important that gaps/deficiencies in existing arrangements are identified, and that the new arrangements do not simply amalgamate or duplicate existing arrangements. The new arrangements must add value, lower the cost of regulation and be effective on a national basis.

⁷ Discussion Draft, Box 9.3, page 217

⁸ Discussion Draft, page 216

⁹ Page 218 of the Discussion Draft

The work being carried on as part of the energy market reform program must also distinguish between consumer protection issues and market design issues.

It is the ERAA's view that development of a national framework for energy must be developed in accordance with the following principles:

- Competition is to be preferred over regulation, and represents the most effective form of customer protection;
- The Trade Practices Act, Privacy Act and Fair Trading legislation provide for a comprehensive National Consumer Protection regime across all jurisdictions (Duplicating provisions within energy regulation increases compliance cost and complexity with no associated increase in consumer protection);
- High standards, including clear objectives and tests against best practice regulation, must be met to justify the adoption of energy specific or jurisdictional specific regulations;
- The regulatory framework should allow for efficient regulatory change management processes to enable regulatory arrangements be improved or modified when necessary; and
- National consistency should not be viewed as an end in itself, but a means to improving the quality of regulation.

It is our view that a national regime to licensing and consumer protection codes is preferable to the retention and continuation of the current jurisdictional approach.

Appropriate institutional and governance arrangements

The move towards a national regulator provides an opportunity to improve on the current institutional and governance arrangements.

The following principles are critical for an effective institutional and governance framework:

- Adequate consultation with all stakeholders, including industry, consumer groups and governments in all steps of the process;
- Transparent, clear and well defined objectives and decision making frameworks for the new institutions;
- Delineation of responsibility for rule making and enforcement; and
- Appropriate appeal rights and accountability for market funded institutions.

At this stage, there is not a clear and well-defined process to achieve these outcomes. There must be recognition of the need to deliver these outcomes and a process to achieve these.

There is an issue about the relationship between the regulatory bodies, in particular the Australian Energy Regulator (AER) and the Australian Competition and Consumer

Commission (ACCC). Accordingly, the ERAA welcomes the Commission's acknowledgment that the MCE should seek to resolve any outstanding issues concerning operation and governance of AER & AEMC as soon as possible.

This requires consideration of roles of the AER and AEMC. The MCE has endorsed the "separation of powers" principle. That is, there must be a clear distinction between the power to create a regulatory obligation and the power to enforce that obligation. This principle is essential to maintaining the integrity of regulatory processes and the confidence of industry participants in those processes. There must be explicit recognition of the need for clarity of roles and that the principle of separation of powers is reinforced and is adhered to.

We are concerned that certain fundamental principles are not clearly incorporated into elements of the MCE reform program. These principles include transparency, appropriate consultation, appropriate governance and institutional arrangements, strong appeal rights and accountability for market funded institutions. The ERAA requests that the importance of these principles be recognised.

If you have any queries on the content of this submission, please contact myself or Diane Campbell at the ERAA Secretariat on (02) 9369 3263.

Yours sincerely,

Transmission by Email

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