2 December 2005

Mr Ian Primrose
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The Independent Competition and Regulatory Commission
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CIVIC ACT

By email to: ian.primrose@act.gov.au

Dear Ian

ISSUES PAPER: RETAIL PRICES FOR NON-CONTESTABLE ELECTRICITY CUSTOMERS

Origin Energy (Origin) welcomes the opportunity to provide comment on the November Issues Paper *Retail Prices for Non-contestable Customers.*

We understand the Commission has a complex task ahead of it, and seek to assist the Commission in its consideration of the issues.

Overall, we suggest the Commission take guidance from the debates on this issue held elsewhere, both in the energy industry and more broadly. Its goals might be better met if it seeks to redefine its approach to assess primarily whether the *structure* of the market itself provides for competition, and specifically whether there is any evidence of a *capacity for misuse of market power* to charge monopoly rent or restrict entry.

There may well be a role in the Commission's decision-making process for the other information collected in the review, but this should be subordinate to the primary task of determining the presence and level of any barriers to entry.

These comments are explained in detail below.

The need for a decision-making framework

Consistent with FRC reviews in other Australian jurisdictions, the Commission appears to be seeking to find the answers through the information collection process itself, rather than developing a framework from which to interpret information and make decisions.

This approach will result in a complex task being made even more complex, as there will be no clear way to evaluate and trade off the various inputs. For example, how would the Commission value the hypothetical findings of 'low customer churn', 'insufficient marketing', and 'high customer awareness' to arrive at a finding?

We believe that some indicators of an effective market are more meaningful than others, and should be prioritised accordingly, as discussed below.

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Indicators of effective competition: structure versus outcomes

The Commission has stated that in its assessment of competition in the ACT electricity market it will address, among other things, churn rates, pricing, and the emergence of new tariff offerings.

We believe that while these factors may be helpful in mapping the market and its characteristics, they are ultimately unhelpful as primary indicators of an effective market as *there is no clarity about what would adequately demonstrate an effective market*. There are no objective studies that demonstrate what is 'enough' churn, or what is the 'right' price, and there is no agreement in regulatory or academic circles about these matters even on general terms.

The FRC evaluations of the Victorian Essential Service Commission and the UK regulator Ofgem show that even where competition has been decided to be effective, this decision is made 'on balance' and not a result of observing unambiguous indicators of competition. For example, to this point, no regulator has been able to identify what is a 'good' or 'efficient' price (or range of prices) and use this to determine how well competition is working. Even if efficient prices are viewed as those that are close to cost inputs, regulators do not have access to true cost information in a dynamic environment. In any event, the presence of high profit does not itself reflect an ineffective market.

Real world outcomes by their nature are dynamic and uncertain, and thus cannot be predicted or assessed objectively in any long term sense. This is indeed the reason why markets are the preferred tool of governments worldwide for resource distribution, with a market's efficiency due to it being the best means by which to order the ever changing range of complex information available (which is unknowable to any one entity).

We suggest that the most meaningful indicators of competition are those related to structure, particularly those that can inform a view about the *degree of market power* possessed by incumbents and specifically the degree to which this market power may be exercised in an ongoing way to charge monopoly rents or excess prices or restrict entry. Misuse of this type of market power is the market failure which should prompt regulatory intervention, and already has legal precedent through the *Trade Practices Act 1974* and legal interpretation of the Competition Principles.

However, demonstrating an effective market through showing a lack of significant market power (held by any entity) does not require many sellers. Highly concentrated markets can still be contestable if there are low barriers to entry or exit, limiting the incumbent firm's ability to raise its price above competitive levels. The presence of potential competitors waiting to take advantage of any lucrative profits and unhappy customers is enough to keep incumbents attentive to pricing in a way that consumers find acceptable and mitigates misuse of market power.

This view has been supported by the frequently quoted Australian Trade Practices Tribunal (QCMA, 1976) observation: "it is the threat of the entry of a new firm or a new plant into the market which operates as the ultimate regulator of competitive conduct".[1] While retail energy markets are not perfectly contestable, as market entry and exit are not costless, there are still generally very few barriers to entry to a retail market with respect to traditional factors such as high upfront capital investment costs.

[1] See the Appendix for the full reference.

When factors such as customer churn (which we acknowledge is low in the ACT) are used to demonstrate a lack of competition, this only demonstrates a lack of competition as narrowly defined. It does not follow that market forces are not present, or sufficiently capable of regulating prices. Low retailer and customer participation only means that prices are not yet at the level that encourage market involvement by either competing retailers or disgruntled/eager consumers. This may well be a result of effective market forces.

To be clear, this definitional issue is not about 'potential' competition, as addressed by the Commission. Attempting to answer whether there is adequate 'actual' and 'potential' competition in a market sets the Commission up for an impossible task. These questions are undefinable and unknowable, as 'competition' is a complex and dynamic concept, and its outcomes are unpredictable. Further, with the market reasonably new, there is no meaningful precedent for its specific conditions.

We believe the question to be addressed is whether the market *structure* itself *provides for competition*. Given that the Minister has requested the Commission address the "competitive state of the market", and has not explicitly asked for results on notional competitive indicators, this way of conceptualising the issue has been provided for.

There is now a body of statutory law (e.g. s 46 of the TPA) and case law (e.g. Queensland Wire v BHP, Boral v ACCC) that define the requirements of a competitive market. These focus on market structure, and specifically, the presence or otherwise of barriers to entry. The starting point of *all* regulatory assessments of a competitive market should be this existing statutory and case law framework around competition law, and not some industry and even jurisdictional specific notion of what the outcomes of 'effective competition' would look like, or what is 'enough churn'.

To the extent a regulator wants to move to an industry specific approach, the onus is on that regulator to justify why it requires a different concept from that established under national competition law and elaborated by the High Court.

Regulated electricity prices in the ACT

Origin contends that if there are no significant barriers to entry and customers are free to make adequately informed decisions about their choice of retailer, price regulation should be left to the market. If required, this might be supplemented with monitoring and intervention rights for the Commission (or preferably the AER or ACCC) based on agreed and transparent criteria.

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

The inevitable errors in regulatory price setting can also mean that allowable prices are *higher* than that which the market would set, which also does not benefit consumers. As an illustration, when visiting Victoria a couple of years ago, the former head of Ofgem spoke to industry stakeholders about his experience with price cap regulation in the UK. He advised the group that when his office first took the decision to remove price regulation in UK, he was extremely surprised to find that the prices subsequently provided by retailers to consumers were in fact *lower* than the level the regulator would have set had regulation continued. Consumers thus received a greater benefit from market forces being allowed to work than they would have from the regulator's decision-making.

Please contact either Fiona Watters (03 9652 5878) or Beverly Hughson (03 9652 5702) if you would like to discuss any element of this submission.

Yours faithfully

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Appendix: The Nature of Competition

From Australian Trade Practices Tribunal (now the Australian Competition Tribunal) in *Re Queensland Co-operative Milling Association Ltd; Re Defiance Holdings Ltd* (QCMA) (1976) 25 FLR 169.

> Competition may be valued for many reasons as serving economic, social and political goals. But in identifying the existence of competition in particular industries or markets, we must focus upon its economic role as a device for controlling the disposition of society's resources. Thus we think of competition as a mechanism for discovery of market information and for enforcement of business decisions in the light of this information. It is a mechanism for firms discovering the kinds of goods and services the community wants and the manner in which these may be supplied in the cheapest possible way. Prices and profits are the signals which register the play of these forces of demand and supply. At the same time, competition is a mechanism of enforcement; firms disregard these signals at their peril, being fully aware that there are other firms, either currently in existence or as yet unborn, which would be only too willing to encroach upon their market share and ultimately supplant them.
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> This does not mean that we view competition as a series of passive, mechanical responses to "impersonal market forces". There is of course a creative role for firms in devising the new product, the new technology, the more effective service or improved cost efficiency. And there are opportunities and rewards as well as punishments. Competition is a dynamic process; but that process is generated by market pressure from alternative sources of supply and the desire to keep ahead.
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> As was said by the U.S. Attorney-General's National Committee to Study the Antitrust Laws in its Report in 1955 (at p.320):
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> > "The basic characteristic of effective competition in the economic sense is that no one seller, and no group of sellers acting in concert, has the power to choose its level of profits by giving less and charging more. Where there is workable competition, rival sellers, whether existing competitors or new potential entrants into the field, would keep this power in check by offering or threatening to offer effective inducements...."
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> Or again, as is often said in U.S. antitrust cases, the antithesis of competition is undue market power, in the sense of the power to raise price and exclude entry. That power may or may not be exercised. Rather, where there is significant market power the firm (or group of firms acting in concert) is sufficiently free from market pressures to "administer" its own production and selling policies at its discretion. Firms may be public spirited in their motivation; but if their business conduct is not subject to severe market constraints this is not competition. In such a case there is substituted the values, incentives and penalties of management for the values, incentives and penalties of the market place.
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> Competition expresses itself as rivalrous market behaviour. In the course of these proceedings, two rather different emphases were placed upon the most useful

form such rivalry can take. On the one hand it was put to us that price competition is the most valuable and desirable form of competition. On the other hand it was said that if there is rivalry in other dimensions of business conduct - in service, in technology, in quality and consistency of product - an absence of price competition need not be of great concern.

In our view effective competition requires both that prices should be flexible, reflecting the forces of demand and supply, and that there should be independent rivalry in all dimensions of the price-product-service packages offered to consumers and customers.

Competition is a process rather than a situation. Nevertheless whether firms compete is very much a matter of the structure of the markets in which they operate. The elements of market structure which we would stress as needing to be scanned in any case are these:

(1) the number and size distribution of independent sellers, especially the degree of market concentration;

(2) the height of barriers to entry, that is the ease with which new firms may enter and secure a viable market;

(3) the extent to which the products of the industry are characterised by extreme product differentiation and sales promotion;

(4) the character of "vertical relationships" with customers and with suppliers and the extent of vertical integration; and

(5) the nature of any formal, stable and fundamental arrangements between firms which restrict their ability to function as independent entities.

Of all these elements of market structure, no doubt the most important is (2), the condition of entry. For it is the ease with which firms may enter which establishes the possibilities of market concentration over time; and it is the threat of the entry of a new firm or a new plant into a market which operates as the ultimate regulator of competitive conduct.