



## **Competition: a market failure?**

**Review of regulated retail prices and charges for gas from 1 July 2016**

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**Energy + Water Consumer Advocacy Program**



## **1. The Public Interest Advocacy Centre**

The Public Interest Advocacy Centre (PIAC) is an independent, non-profit law and policy organisation that works for a fair, just and democratic society, empowering citizens, consumers and communities by taking strategic action on public interest issues.

PIAC identifies public interest issues and, where possible and appropriate, works co-operatively with other organisations to advocate for individuals and groups affected. PIAC seeks to:

- expose and redress unjust or unsafe practices, deficient laws or policies;
- promote accountable, transparent and responsive government;
- encourage, influence and inform public debate on issues affecting legal and democratic rights;
- promote the development of law that reflects the public interest;
- develop and assist community organisations with a public interest focus to pursue the interests of the communities they represent;
- develop models to respond to unmet legal need; and
- maintain an effective and sustainable organisation.

Established in July 1982 as an initiative of the (then) Law Foundation of New South Wales, with support from the NSW Legal Aid Commission, PIAC was the first, and remains the only broadly based public interest legal centre in Australia. Financial support for PIAC comes primarily from the NSW Public Purpose Fund and the Commonwealth and State Community Legal Services Program. PIAC also receives funding from NSW Trade and Investment for its work on energy and water, and from Allens for its Indigenous Justice Program. PIAC also generates income from project and case grants, seminars, consultancy fees, donations and recovery of costs in legal actions.

### **Energy + Water Consumer's Advocacy Program**

This Program was established at PIAC as the Utilities Consumer's Advocacy Program in 1998 with NSW Government funding. The aim of the program is to develop policy and advocate in the interests of low-income and other residential consumers in the NSW energy and water markets. PIAC receives policy input to the program from a community-based reference group whose members include:

- Council of Social Service of NSW (NCOSS);
- Combined Pensioners and Superannuants Association of NSW;
- Tenants Union of NSW;
- Ethnic Communities Council of NSW;
- Physical Disability Council of NSW;
- St Vincent de Paul Society of NSW; and
- The Salvation Army Eastern Australia Conference.

## 2. Introduction

PIAC welcomes the opportunity to comment on the Independent Pricing and Regulatory Tribunal's (IPART) issues paper, *Review of regulated retail prices and charges for gas from 1 July 2016* (the issues paper).<sup>1</sup>

The New South Wales government is in the process of deregulating gas prices. While customers are able to choose from a number of market offers, many remain on standard contracts. There are three standard retailers who offer contracts with prices that are regulated by IPART through Voluntary Pricing Arrangements (VPA). The VPAs are due to expire in 2016. Given the uncertainty in the wholesale gas market and the lack of competition in regional NSW, new VPAs will be negotiated for the period of 1 July 2016 to 30 June 2017.<sup>2</sup>

The issues paper outlines the retail price review process, including the assessment of the retailers' proposed average price changes and forecast costs, the retailers' approach for determining average costs, price control and the mechanisms to manage risk. In addition, IPART will also review the competitiveness of the retail gas market in NSW.<sup>3</sup> The final step before full retail price deregulation is deemed to be appropriate requires an improvement in the level and effectiveness of competition, especially in regional NSW.<sup>4</sup>

The issues paper is the first step in this review process. As the next step, IPART has asked the three standard retailers to prepare their VPAs, which are due to be submitted to IPART in late January for public comment. Finally, IPART will release a draft proposal in April before the final determination in early June 2016. IPART will make its determination based on its assessment of competition in the market and the standard retailers' proposals, with particular focus on the proposed forecast costs and prices and whether these are efficient for supplying a small customer.<sup>5</sup>

## 3. Wholesale gas market

The east coast wholesale gas market is undergoing significant changes and this has resulted in market and price uncertainty. Much of this uncertainty has been driven by the introduction of liquefied natural gas exports. This has linked for the first time the east coast domestic gas market with the international gas market, leading to speculation and fears that domestic gas prices will increase as a result. In addition, the development of short-term gas trading markets across the east coast has not been as successful as anticipated.

Together, these factors have led to two major reviews of the market. The Federal Minister for Small Business tasked the Australian Competition and Consumer Commission (ACCC) with undertaking an extensive inquiry into the east coast gas market. The ACCC is due to release the final report in April 2016. In addition, the Council of Australian Governments Energy Council

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<sup>1</sup> IPART, Issues Paper, *Review of regulated retail prices and charges for gas from 1 July 2016*, November 2015

<sup>2</sup> Ibid 1.

<sup>3</sup> Ibid 5.

<sup>4</sup> Ibid 9.

<sup>5</sup> Ibid 13.

(COAG EC) tasked the Australian Energy Market Commission (AEMC) with undertaking an extensive review of the east coast gas market and pipeline framework. Separately, the Victorian government requested that the AEMC review the Declared Wholesale Gas Market. This process and the East Coast Gas review have been rolled into one. The AEMC is due to issue the final report for stage 2 of the review in 2016, a draft of which was published at the beginning of December 2015.

Jemena, the largest distribution network in NSW, is appealing the Australian Energy Regulator's (AER) decision on its access agreement for the 2015-2020 period. The outcome of this appeal (due in December 2015) will have a material impact on the prices of AGL, which is the standard retailer in the Jemena supply area. The AER decision as it stands would result in a 12% decrease in the distribution component of a residential customer's bill. However, if Jemena's appeal is successful, this saving for consumers may be reduced, and Jemena would be able to recover the cost of lower prices from July 2015 until the decision is made, from their customer base.

One of the conditions for the full deregulation of retail gas prices is effective competition. Given the current uncertainty and large-scale issues in the gas market, PIAC submits that it would be prudent to consider the recommendations from both the AEMC and ACCC reviews as a precondition to full deregulation.

## 4. Competition and consumers

### 4.1 Competition

IPART has stated that it views competition as 'the best form of protection for customers'<sup>6</sup> and will use this review and the AEMC's annual competition review<sup>7</sup> to identify areas to improve competition within the retail gas market. IPART will focus on:

- barriers to entry, exit and expansion;
- customer participation and outcomes;
- price movements; and
- rivalry and price and product diversity.<sup>8</sup>

The intended outcome of the review is to determine whether there has been a material increase in competition in the market. IPART has not outlined how it will determine whether there has been a 'material' increase, but has indicated that low barriers to entry for a new retailer are the most important indicator of competition.<sup>9</sup>

While the objective of the review is to examine competition on the assumption that an increase is to the ultimate benefit of consumers, the truth or otherwise of this underlying assumption needs to be tested. PIAC is concerned about the lack of a consumer-centric indicator of the effectiveness of competition. Multiple indicators are required to form a complete picture of the state of competition. For example, a high degree of choice for consumers is meaningless unless it is

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<sup>6</sup> Ibid 16.

<sup>7</sup> AEMC, Final Report, *2015 Retail Competition Review*, 30 June 2015.

<sup>8</sup> IPART, above n 1,16.

<sup>9</sup> Ibid 17.

accompanied by appropriate, accessible and reliable information that allows customers to determine which is the best deal for them. More choice also means there is an additional time-cost for consumers to search around for the best deal. It has been found that more choice usually benefits wealthier and better-educated consumers, whereas customers with lower education levels and vulnerable customers incur higher transaction costs in relation to these choices.<sup>10</sup> More generally, introducing competition into a market for an essential service can be also a form of risk transfer from the energy provider to the resident or consumer.<sup>11</sup>

A recent analysis of competition in public service industries across Europe, including the energy sector, found that effective choice, not market competition, had better outcomes for customers, particularly vulnerable customers. The study found that customers with lower education levels had lower 'service affordability', and that this gap disappeared when choices were easy to understand and where quality choices were available. These accessibility factors meant that the customers were able to take advantage of the better offers in the market. The results also found that demand-side regulation is critical in providing protections and reducing inequality in the market. It is clear that regulatory instruments remain an important means of protection for customers.<sup>12</sup>

The NSW gas market has been open to full retail competition since 2002; however, full price deregulation has not occurred. Even though some new retailers have entered the market since then, it is still dominated by three large retailers that serve 96% of all customers in the state.<sup>13</sup> For many customers outside of the metropolitan areas, there is only one retailer with two offers to choose from.<sup>14</sup> Given the current levels of retail competition, PIAC takes the view that competition in NSW has stalled. In this context, it will be important to determine what level of competition is to be deemed to be effective and how the analysis will incorporate the essential consumer-centric element. PIAC reiterates that it is not enough to have a high degree of choice; the choices need to be quality choices and there needs to be accessible information about these choices to ensure that customers are able to make meaningful decisions. This is particularly the case for vulnerable and time-poor customers who may not be able to act on the choices that are available, and thus remain on standard contracts and pay more than they need to for essential energy services.

Without an analysis of the effect on consumers, who are the intended beneficiaries of increased competition, a review of competition is not meaningful and cannot answer the key question of whether the system is working in the long-term interests of consumers. In other words, PIAC accepts that competition is generally good for consumers, but competition cannot be treated as a guarantee of good consumer outcomes in any particular market.

Therefore, PIAC recommends that IPART include demand-side customer-centric indicators in its review of competition in the NSW retail gas market, and consider the impact on consumers who

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<sup>10</sup> Fernandez-Gutierrez M. James, O and Jilke, S. 'Competition and switching in public service markets' (2015) *Regulation and Governance*, 6.

<sup>11</sup> Needham, C. *The reform of public services under new Labour. Narratives of consumerism.* (2007). Palgrave Macmillan, New York. 74.

<sup>12</sup> Fernandez et al, above no 10 2.

<sup>13</sup> AER *Annual report on the performance of the retail energy market 2014-2015.* 2015, 9.

<sup>14</sup> AER, *Retail Statistics* (2015) <https://www.aer.gov.au/retail-markets/retail-statistics>. Accessed on 4 December 2015.

stay on standard contracts when evaluating the proposed standard contract prices for the coming year.

### **Recommendation 1**

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*PIAC recommends that IPART take account of the customer indicators, such as debt, hardship and complaints when assessing the effectiveness of competition in the NSW retail gas market.*

### **Recommendation 2**

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*PIAC recommends that IPART take account of the impact on customers who, for many reasons, are unable to make a choice and stay on the standard contract when setting prices for the coming year.*

## **4.2 Customer complaints and debt**

In 2014-15, customer complaints about gas retailers to the Energy and Water Ombudsman (EWON) increased by 8% from the previous year.<sup>15</sup> This could indicate that consumers are not satisfied with the outcomes of competition. If we are only assessing competition by looking at the number of plans available, but ignore the satisfaction of customers, we miss an important part of the picture. Customer satisfaction should also be an indicator of the effectiveness of competition.

The number of customers on hardship programs has increased from 3884 as of June 2014 to 4375 as of June 2015. Similarly, the number of customers on payment plans has increased from 10,584 to 17,885.<sup>16</sup> At the same time, customer debt levels have increased. The average debt is \$450, and there are significant numbers of customers with higher debt levels. According to the AER, there are 37,785 customers with debt below \$500; 7362 customers with debt over \$500 but less than \$1500; 1867 customers with a debt between \$1500 and \$2500; 1535 customers with debt over \$2500.<sup>17</sup> There are a total of 48,549 customers in NSW who have a gas debt, which is a greater proportion of gas customers than electricity customers with an energy debt.<sup>18</sup> No figures are available to indicate how many customers have both a gas and an electricity debt, but customers who have one debt generally tend to have multiple debts across different service types (for example, energy and personal credit).

Gas affordability is decreasing, especially for low-income households both with and without concessions; for these consumers gas makes up 3.5% of their household annual income. Comparatively, for households with a higher income, this drops to 0.4% of their annual income.<sup>19</sup>

Given the current debt levels, it is no surprise to see that the number of disconnections has also increased, with only 61% of these being reconnected.<sup>20</sup> During 2014-15, 7555 households were disconnected from gas in NSW.<sup>21</sup> This is an increase of 49% from the previous year and an indication that gas is increasingly becoming more unaffordable for households.<sup>22</sup> PIAC recommends that IPART consider these debt and hardship indicators in its evaluation of the

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<sup>15</sup> EWON. EWONews: A newsletter from the Energy and Water Ombudsman NSW. Issue 31 June 2015, 5.

<sup>16</sup> AER, above n 14

<sup>17</sup> Ibid.

<sup>18</sup> Ibid.

<sup>19</sup> AER above no 13, 9.

<sup>20</sup> Ibid 34.

<sup>21</sup> Ibid 36.

<sup>22</sup> Ibid 32.

proposed standard contract prices for the coming year and adopt prices at the lower range of that proposed by the standard retailer to protect customers from potential bill increases.

### **Recommendation 3**

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*PIAC recommends that IPART take account of the current debt and hardship levels and the unaffordability of gas in its review of competition and when setting the standard contract price for NSW residential gas customers.*

## **5. Proposed average changes in regulated prices, fees and charges**

The cost of wholesale gas has not reached the peak that was predicted a year ago. In fact, the international gas price has dropped significantly as the price of oil has decreased to approximately US\$40 a barrel.<sup>23</sup> However, this drop in price is not reflected in the domestic gas price. The decline of the Australian dollar has contributed to this, but this only partially offsets the price decrease.<sup>24</sup> It is unclear why domestic customers are not benefiting from the low international gas price.

Given the difficulties that many existing gas customers are having in securing new gas contracts, it would be expected that a new retailer would buy gas on the short-term trading market (STTM) rather than through bilateral contracts.<sup>25</sup> The lower prices from the STTM should be reflected in how much the standard retailers are allowed to charge. Given the difficulty new retailers are having securing long-term gas supply contracts and navigating the STTM, there does not appear to be room for an increase in competition in the foreseeable future.

The level of competition in NSW has not improved in the past two to three years. IPART has suggested it will again set the price based on the efficient costs of a new entrant into the market. So far, this has not encouraged new entrants and has allowed the three established retailers to earn increased profits as a result of higher prices.

Moreover, there is little analysis of the difference in risk between a standard retailer and a market retailer. It is unclear why the standard retailers require a retail margin to manage variations in demand and economic conditions. These are a factor of doing business and the standard retailers should not be compensated as customers shift off the standard contracts, given the standard retailers are the three largest retailers and the most likely outcome is that customers will be shifting to one of their market contracts.

In the 2014 final report detailing the changes in regulated retail gas prices from 1 July 2014, IPART predicted that 90% of small gas customers in NSW will be on market offers by 2016. To meet that target, by 2015, 85% of customers should be on market offers.<sup>26</sup> In the recent AER

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<sup>23</sup> Wall Street Journal, *Brent crude falls; Oil prices end at nearly seven-year lows*, <http://www.wsj.com/articles/oil-prices-rise-but-more-pain-is-expected-1449577680>, Accessed on 10 December 2015.

<sup>24</sup> IPART, above n 1,27.

<sup>25</sup> Sims, R., *The importance of adequate competition for the east coast gas market*, Speech to Eastern Australia's Energy Markets Outlook, 17 September 2015.

<sup>26</sup> IPART, *Final Report, Changes in regulated retail gas prices from 1 July 2014*. June 2014, 53.



retail performance report, only 76% of customers were on market contracts as of 1 June 2015.<sup>27</sup> The timing of the shift from standard to market contract was based on the adoption of the standard retailers' VPAs. However, the predicted pace of customers moving to market contracts has not eventuated during this pricing period. AGL and ActewAGL's regulated prices for 2013/14 included customer acquisition and retention costs (CARC). They are established retailers with a high proportion of market share, so it is unclear to PIAC why they should be allowed to recover these costs from standard contract customers. IPART determined that the current CARC costs were sufficient to facilitate the transition of customers onto market contracts.<sup>28</sup> Clearly, this is not the case. If the extra allowance is not working, PIAC submits that it should be removed from the regulated price.

Given the increase in household gas debt, disconnection and hardship, and the failure to shift customers onto market contracts, PIAC recommends that IPART not set the price at the retail price of an efficient new entrant. PIAC recommends that retail-operating costs be set at the lower end of the proposed range of \$91 to \$110 per customer, and that IPART not allow retailers a retail margin at the higher range of 7.3%.<sup>29</sup>

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#### **Recommendation 4**

*PIAC recommends that IPART remove the CARC allowance for the standard retailers, as it is not facilitating customer switching to market contracts.*

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#### **Recommendation 5**

*PIAC recommends that IPART review its policy of setting the price based on the costs of a new entrant into the market as this does not encourage new entrants and allows the established retailers to earn higher profits.*

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#### **Recommendation 6**

*PIAC recommends that IPART set the retail operating costs at the lower value of \$91 and not the higher value of \$110.*

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#### **Recommendation 7**

*PIAC recommends that IPART set the retail margin at the lower value of 6.3% and review the building block components to ensure this is an accurate reflection of the risks to the standard retailers.*

## **6. Conclusion**

It appears to PIAC that competition in the gas market has stalled in NSW and that light regulation of the standard retailers has failed to effectively protect customers. Accordingly, PIAC recommends that IPART use the current review of competition to assess competition from the customer perspective and to examine the impact of the previous price increases on customers. Given the uncertainty and the current major gas market reviews, PIAC recommends that IPART adopt a precautionary approach to determining the VPAs for the coming period.

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<sup>27</sup> AER, above n14.

<sup>28</sup> IPART above n1, 29.

<sup>29</sup> Ibid, 29.