

Assessing the competitiveness and efficiency of the Victorian energy retail market

Framework and approach

17 December 2019

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Summary

In 2017, the *Independent Bipartisan Review of Electricity and Gas Retail Markets* (independent review) released its report into the retail energy market in Victoria. The review concluded that the market was not working for consumers.¹ In reaching its conclusion, the review also found that Victorians were paying ‘unusually high’ electricity prices compared to other jurisdictions.² The review made 29 recommendations aimed at improving energy market outcomes for consumers.³

The government has requested the commission to implement recommendation 8A from the independent review, which requires the commission to monitor and report on the competitiveness and efficiency of the Victorian retail energy market. The commission has also asked to develop a framework to carry out an assessment on the market. The commission is required to complete its review by 31 December 2019. The commission has also since been given an on-going role to monitor and report on the competitiveness and efficiency of the Victorian retail markets for electricity and gas.⁴

We have developed a framework and approach which we believe captures the key reasons why reporting on the energy market is important. We have also consulted widely to ensure we reflect what is important to the community.

What sort of outcomes should Victorian energy consumers receive?

We are looking for competition in the market that delivers positive long-term outcomes for Victorian consumers – a market with effective competition. This recognises that competition is a means to an end rather than an end in itself and measuring the competitiveness and efficiency of the market can indicate what effect the market is having on customer outcomes. This is particularly important given that energy is an essential service where the overwhelming majority of customers cannot exit or find a fully substituted product.

Can a highly competitive and efficient market deliver these outcomes?

Victoria became the first Australian jurisdiction to initiate steps towards full retail competition in 1994. At the time, it was expected that the introduction of full retail competition in the energy

¹ Independent Review Panel, *Independent Review of the Electricity and Gas Retail Markets in Victoria*, August 2017, p.ix

² *ibid*, p.ix

³ *ibid*, p.xi-xiii

⁴ Essential Services Commission Act 2001, s10AAB

market would deliver positive outcomes for most Victorian consumers. Policy makers believed that full retail competition would deliver positive outcomes for customers because there would be genuine and vigorous rivalry between retailers because customers would exercise their ability to choose the retailer that provides them with the service they want.

The degree to which competition would provide the same benefits to vulnerable customers is less clear. As energy is an essential service, it is imperative that all customers experience positive outcomes. Where there is uncertainty as to whether a highly competitive market can deliver positive outcomes for all customers, other protections need to be put in place.

The Victorian energy market has failed to deliver these outcomes

Recent reviews have concluded that the Victorian energy market does not exhibit the characteristics of a highly competitive and efficient market. Although some indicators, such as market concentration, suggest the energy market is quite competitive, other observations suggest otherwise. This is particularly evident in the current pricing practices of retailers who engage in pricing strategies (such as conditional discounting) that make it very difficult for a customer to understand and compare the vast array of offers. There was also evidence that the retail charges being earned in the Victorian market are among the highest in the country.⁵

Our framework and approach to measure effective competition

We have developed a framework to help us monitor and report on the competitiveness and efficiency of the market. It will enable us to uncover insights that can meaningfully shape regulatory and policy decision-making, particularly when identifying evidence of market failure.

The classic framework for assessing the competitiveness and efficiency of a market is the structure, conduct and performance framework (SCP framework), which has been applied across many markets for decades. We recognise that this is a rational and structured framework for considering markets.

We will use an amended framework that builds on this framework, by drawing out how retailers and customers interact in the market. Our framework will capture the following questions:

- Is the market structured to facilitate competition?
- What are retailers offering to customers in the market?
- How are customers responding to retailers?
- How are retailers performing for customers?

⁵ Independent Review Panel, 2017, *Independent Review of the Electricity and Gas Retail Markets in Victoria*, August 2017, p53.

We also know that there is no single indicator that shows whether the market is sufficiently efficient or demonstrates effective competition. Therefore, we will use a 'systems thinking' approach that allows us to consider how different components of the market interact and influence each other.

We will use the following approach when analysing the market and publishing our findings:

- **Understandable:** readers will be able to clearly see how we have used the framework and how this has led to our assessment of the market and any recommendations
- **Evidence-based:** the framework will be underpinned by quantitative and qualitative data for our indicators as well as robust analysis of the insights they provide
- **Multifaceted:** we will not rely on a single indicator or any category of indicators, such as market structure, to assess the competitiveness and efficiency of the market. Instead we will analyse the indicators and understand and explain how they interact with each other.

What will our report provide?

The commission will begin monitoring the market from 2020, using this framework and approach. In the lead up to the first report the commission will continue to engage to ensure the first report best meets the needs of stakeholders.

Our first report will focus on two major symptoms for why we believe there is a gap between our current market and a fully effective market:

- Lack of genuine innovation. Genuine innovation (both demand and supply side) should result in better outcomes for consumers whether it be from new products or a step change in costs.
- Low levels of trust. Trust ought to be present for the market to be effective for all customers, particularly customers experiencing vulnerability.

It is also likely that these two focus areas would continue to be a focus for our monitoring and reporting on the market in future years. We are particularly interested in monitoring innovation over time to identify new and emerging energy products or services, and to understand whether the regulatory framework is fostering or hindering innovation in the retail energy market.

It is anticipated that the first report will be released later in 2020.

We want our report to provide value for our community. Customers should be able to read the report and have confidence in the market working in their best interests. Policy makers should be able to use our report to consider what amendments may be needed to improve the outcomes of the market, particularly in areas where there is potential market failure. Retailers should be able to understand how their actions in the market will influence our assessment, and therefore the impact that may have on policy changes.

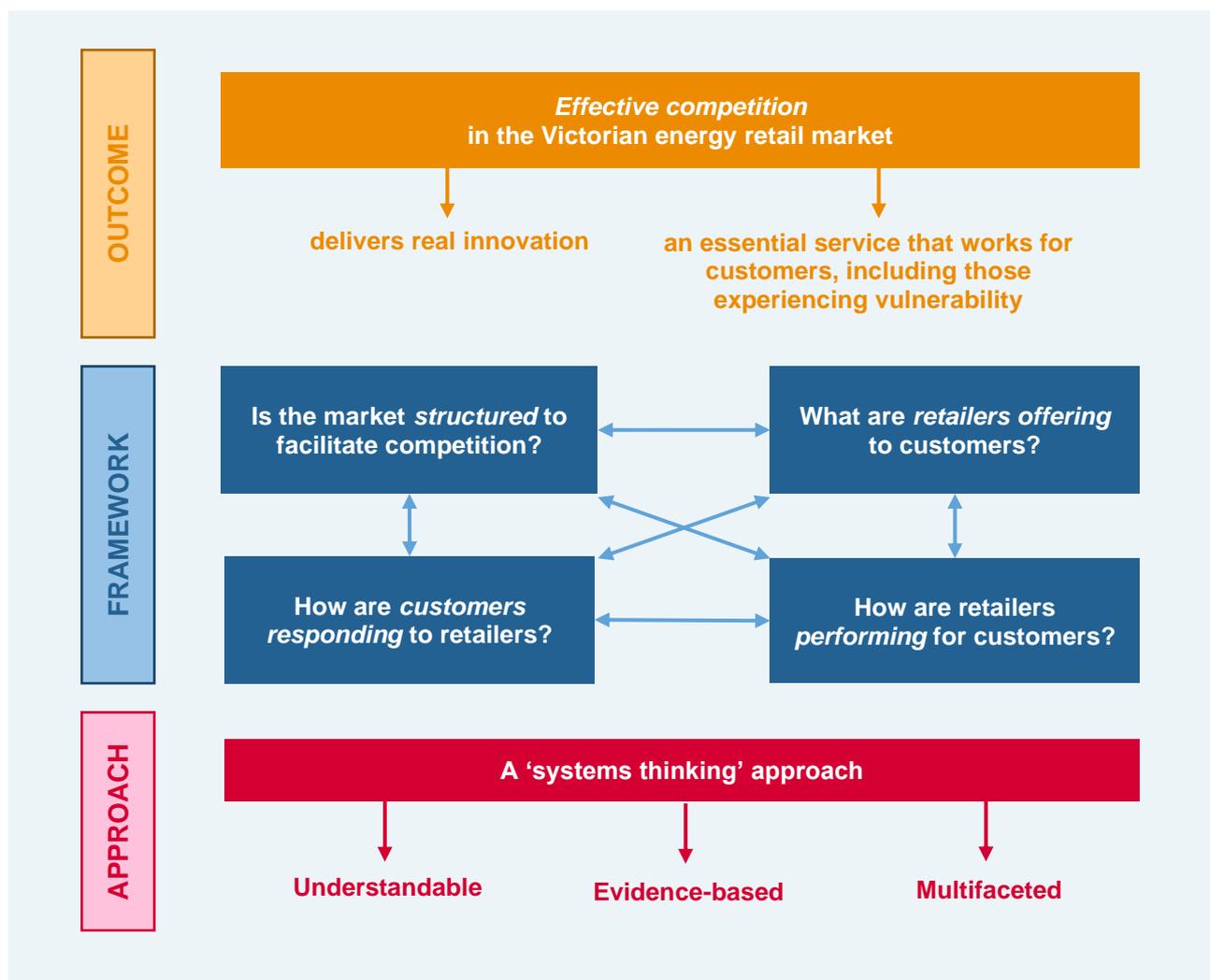
Summary

We welcome stakeholders' contribution to our review, whether it be through formal submissions or attending interviews, meetings and workshops, to help enhance our framework and approach, or to suggest other areas of focus for our first report. Stakeholders are welcome to provide formal submissions to this framework and approach until 30 March 2020.

Summary of our framework and approach

The figure below illustrates the framework and approach the commission will use to assess the competitiveness and efficiency of the Victorian energy retail market.

Figure 1 Summary of our framework and approach



1. Developing our framework and approach

The commission has been asked to monitor and report on the competitiveness and efficiency of the energy market in Victoria, by first developing a supporting framework and approach.

We believe that our framework needs to focus on the outcomes experienced by customers. Our approach will be to examine the outcomes that customers are experiencing from the energy market and compare these to the outcomes that we believe should be achieved for all Victorian consumers.

Our framework and approach have been informed by valuable insights from economic experts and our key stakeholders. We thank all who have provided input and feedback throughout our process to date.

This report sets out the following:

- Chapter 1 describes our role and definition of the Victorian energy retail market, as well as the consultative process we undertook.
- Chapter 2 describes the outcomes for Victorian customers we expect to see from the retail energy market.
- Chapter 3 sets out the framework we would use to measure the competitiveness of the energy market, which is adapted from traditional frameworks.
- Chapter 4 sets out our approach to analysing the market, by applying a method that considers the market as a complex system and considers the potential gap between a fully competitive and efficient market.
- Chapter 5 describes how stakeholders can get involved with our review.

Our role

In March 2018, the Minister for Finance (now Assistant Treasurer) provided the commission with terms of reference pursuant to section 10(g) of the *Essential Services Commission Act 2001* to monitor and report on the competitiveness and efficiency of the Victorian retail energy market. We are also required to have regard to:

- our objectives under the Essential Services Commission Act 2001, Electricity Industry Act 2000, and the Gas Industry Act 2001
- findings from the Independent Review
- approaches being used by other regulators, including Australian and International Regulators, and
- other matters deemed relevant.

1. Developing a framework and approach

We are required to complete and publish our framework for monitoring competitiveness and efficiency by 31 December 2019. A copy of the terms of reference can be found in Appendix A.

We have also since been given an on-going function to monitor and report on the competitiveness and efficiency of the Victorian retail markets for electricity and gas.⁶ This complements our obligations to report on the performance of energy retailers and the price of retail energy offers in the market, particularly through our Victorian Energy Market Report since 2016-17.⁷

The Victorian energy retail market

In Victoria, most customers purchase electricity or gas from licensed energy retailers.

Retailers buy energy in wholesale markets, including the National Electricity Market (NEM) and the Declared Wholesale Gas Market (DWGM). The NEM is an interconnected network along the eastern seaboard, comprising of generators fuelled by a range of sources including gas, coal, water, solar and wind. Most gas bought by retailers is purchased using bilateral gas supply agreements, with the balance purchased via the DWGM. Gas producers are primarily based in Victoria's Gippsland Basin.

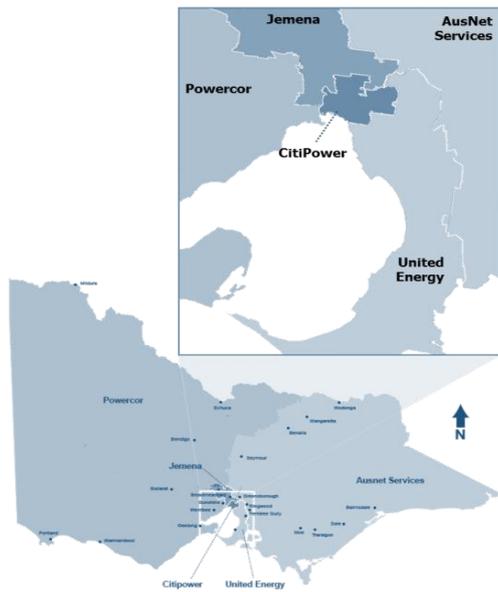
Energy retailers also make arrangements with distribution companies to deliver the energy to customers through electricity poles and wires, and gas pipelines. The distribution companies also measure the amount of energy each customer uses and pass that information onto the retailers. The retailers use this information to issue customer bills. In Victoria, there are five electricity distribution companies and three gas distribution companies (as shown in figure 2).

⁶ Essential Services Commission Act 2001, s10AAB

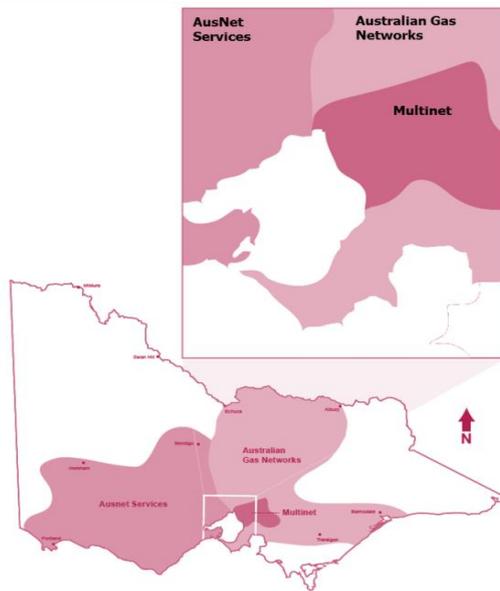
⁷ Essential Services Commission Act 2001, s54V and 54W, Electricity Industry Act 2000, s39A, and Gas Industry Act 2001, s47.

Figure 2 Electricity and gas distributors in Victoria

For electricity

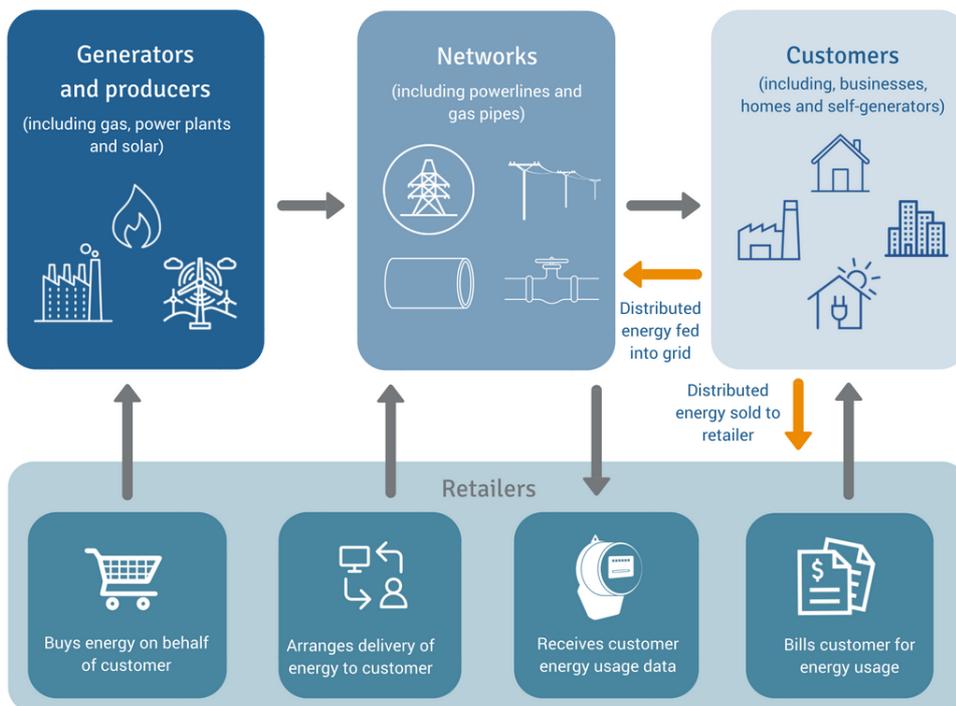


For gas



The price energy retailers charge customers covers the wholesale cost of energy, the cost of delivering it to customers, and the cost of government policy obligations to buy a proportion of renewable energy and energy efficiency services. The price also covers the retailers' cost of billing and customer service and their profit margin. A summary of this is shown in figure 3.

Figure 3 A summary of the energy market in Victoria



1. Developing a framework and approach

When retailers set their prices, they will estimate how much they expect to pay for wholesale energy and its delivery to their customers through the distribution network. The price that distribution businesses can charge for delivering energy is determined by the Australian Energy Regulator.

Retailers currently offer different prices for residential and small business customers. Small business customers generally experience higher prices than residential customers for electricity, but often have lower prices for gas.

It is worth noting that the tariff structures currently offered by retailers for both gas and electricity are typically done so based on the underlying network tariff structure. When retailers derive their tariff structures, they may reflect the underlying tariff structures they are paying to the relevant network operators. There are five network zones for electricity and 13 network zones for gas, each with their own tariff structure and level of prices.

A definition of the Victorian energy retail market

The Victorian energy retail market is a market of on-sellers of gas and electricity to Victorians including residential, small business and commercial or industrial. As such we propose to define the retail energy market as:

A market where consumers of electricity and gas can enter into contracts with businesses to purchase energy on their behalf, organise connection and payment of services to distribute and transmit energy, undertake billing, and where possible provide data to better inform consumption behaviour.

This proposed definition provides focus for our review when considering competitiveness and efficiency of the retail energy market. Therefore, we are proposing to exclude the following, in the first instance, from our review:

- the wholesale market or the rules under which it operates
- the distribution and transmission sectors, or the regulatory rules under which it operates
- the market for generation of electricity or gas, including those that are sold to households or businesses
- any international markets in which gas can be bought or sold.

We are open to considering these elements in our review where it may be appropriate to draw insight or conduct further analysis to understand the Victorian market.

While most Victorian energy consumers, particularly residential and small businesses, purchase energy from retailers that we licence, we are aware that the market is changing. New and emerging business models are serving energy to customers differently to traditional retail models.

1. Developing a framework and approach

For example, this might be through the management of imported and exported power via third-party aggregators, virtual power plants or new community microgrids. We are also conscious that over 140,000 customers are supplied electricity through embedded networks. As part of our monitoring and assessment of the retail energy market, we will keep these new business models and emerging energy service offerings to customers in close view.

Stakeholder question: What other specific sub-markets should we consider in our assessment, particularly those that are different to the traditional model of energy retailing?

A consultative process in developing our framework and approach

There have been several reviews into the energy market in Australia, some of the more recent are discussed in chapter 2. These reviews have helped inform the commission in developing its own framework, approach and monitoring role.

The commission sought to take an open and consultative approach in developing its framework and approach. We first approached a range of economic experts in the area of energy competition to provide views on how the commission could monitor and report on the competitiveness and efficiency of the energy market.

We also hosted a public forum on 7 November 2019 to hear perspectives from a broader group of experts and stakeholders. The forum included:

- Papers and presentations from three respected and expert economists. The papers broadly provided their perspectives on how they would undertake the task of assessing the competitiveness and efficiency of the Victorian energy retail market.
- A panel session comprised of stakeholders, including consumer advocates, industry, regulators, commentators and policy advisors. The panel session provided an opportunity to hear from a broader group of experts about their perspectives, which allowed for a robust discussion between panel members and the broader audience.
- A facilitated activity with forum participants to provide feedback on what stakeholders viewed as the key elements the commission should consider when undertaking its monitoring and reporting role.

Views from economic experts

The commission invited the following economists to prepare a paper and speak at our forum:

- Professor Catherine Waddams, Norwich Business School at the University of East Anglia
- Danny Price, Managing Director at Frontier Economics
- Kris Funston, Partner at Deloitte Access Economics

1. Developing a framework and approach

Each economist prepared a paper providing their views on how they would undertake the task of assessing the competitiveness and efficiency of the Victorian energy retail market.⁸ A brief summary of each of these papers is described in the following sections.

Professor Catherine Waddams: “Competition is a means to an end rather than an end in itself and can be a powerful tool if used appropriately to deliver better offers and outcomes for most consumers.”⁹

This paper notes that an energy market may not deliver great outcomes for all customers, but that this may not necessarily suggest it is not competitive. It also notes the importance of considering what customers are paying, rather than just what is being offered. Customer engagement is also a key consideration – customers may choose to not engage in the market, or it may be because of obstacles, which might be imposed by retailers. A better understanding of these behaviours is needed when making assessment of competition.

Professor Waddams suggests that the Victorian market is performing more favourably than other markets. This is particularly evident in the fact that only around 6 per cent of customers are on the default offer, there are relatively high switching rates, and a higher proportion of customers experiencing hardship would more likely be on a market offer. However, she also observes that pricing practices in Victoria appear to be more complicated and may indicate that the ability of customers to achieve the best deal is more questionable.

Professor Waddams suggests the commission should undertake a multifaceted approach. More of a focus should be on consumer measures, particularly trust and confidence indicators. She suggests using an approach like that proposed by the UK regulator, the Office of Gas and Electricity Markets.

⁸ The papers can be found on the commission website at <https://www.esc.vic.gov.au/electricity-and-gas/electricity-and-gas-inquiries-studies-and-reviews/electricity-and-gas-retail/electricity-and-gas-retail-markets-review-implementation-2018-competitiveness#tabs-container2>

⁹ Waddams Price, C, 2019, *Assessing the competitiveness and efficiency of the Victorian energy retail market*, p1.

Danny Price: “Consumers don’t demand competition *per se*, they demand choice. Consumers want choice because it means that they can shop around for better deals when they feel they are not getting good value or service.”¹⁰

This paper examines the reviews that have been undertaken by the Australian Energy Market Commission, Australian Competition and Consumer Commission, the Independent Pricing and Regulatory Tribunal of New South Wales and the Essential Services Commission of South Australia to assess retail competition. Price observes that these reviews tended to use the widely used structure, conduct and performance (SCP) framework, but suggested the framework has problems. He observed a propensity to determine whether competition exists based on observations of several indicators, without further considering their real effect on the market.

Price suggests that as energy is a homogenous product, a highly competition market should result in prices being very similar. If prices do differ then this would indicate that customers are not fully engaged in the market, and that retailers know this and take advantage of this when developing pricing strategies.

Price proposes the commission develop an index of price spreads that reveal what customers are paying and use the changes in this index to determine the competitiveness of the market. He also proposes that the commission consider other factors when undertaking its assessment, particularly retailer returns.

Kris Funston: “If the Victorian energy market were operating competitively, it would be expected that there would be a high degree of rivalry among energy retailers. This would be reflected in market conduct where retailers engaged in a level of pricing and product differentiation.”¹¹

This paper also observed that the SCP framework has often been used to assess the effectiveness of competition in energy markets in Australia. Funston notes that the SCP framework has its limitations and that the causal relationships between the factors are complex, rather than linear. Therefore, no single measure should be used to assess how competitive the market is.

¹⁰ Price, D (Frontier Economics), 2019, *A framework – paper for the Essential Services Commission*, p 2.

¹¹ Deloitte, 2019, *Economic views on assessing competitiveness and efficiency of the Victorian retail energy market*, p 3.

1. Developing a framework and approach

Funston contends that the energy market should have a dispersed set of prices, as this would be a result of retailers designing different products that better suit customer preferences. However, he also acknowledges that in the Victorian market this is due to pricing strategies of the retailers using higher discounts to attract new customers.

Funston has analysed the performance of the Victorian energy market using the SCP framework and concluded that on many of these indicators it appears to be working quite well. However, as well as the questionable pricing strategies adopted by retailers, he also observes that retail margins appear to be quite high in Victoria when compared to other jurisdictions across Australia, even though most SCP indicators point to a more competitive market.

Funston therefore suggests the commission use the SCP framework as a starting point, with additional indicators to enhance the assessment. He recommends assessing indicators in combination with each other and over time.

A panel session followed each presentation comprised of a broad range of industry and cross-sector experts, and focussed on three separate themes, based on the views presented by the economic expert (as described in table 1).

Table 1 Public forum panel themes and panelists

Theme	Panelists
Customer experience – how should the customer experience be considered when assessing the competitiveness and efficiency of the Victorian energy market?	<ul style="list-style-type: none"> • Professor Catherine Waddams, Norwich Business School at the University of East Anglia • Cynthia Gebert, Energy and Water Ombudsman of Victoria • Assoc. Prof David Byrne, Centre for Market Design at the University of Melbourne • James Garriock, Executive Director, Insync
Price and service quality – what type of changes in retail prices and service quality should the commission be mindful of when considering the competitiveness and efficiency of the market both in the short-term and the longer term?	<ul style="list-style-type: none"> • Danny Price, Managing Director at Frontier Economics • Tony Wood, Grattan Institute • Associate Professor Bruce Mountain, Victorian Energy Policy Centre • Bridget Ryan, Policy and Government Lead, GreenSync
Protecting customers experiencing vulnerability – how do we assess the extent to which a competitive market is producing good outcomes for customers experiencing vulnerability?	<ul style="list-style-type: none"> • Kris Funston, Partner, Deloitte Access Economics • Linda McMillan, Director, Farrier Swier Consulting • David Havyatt, Senior Economist, Energy Consumers Australia

The panel sessions provided further perspectives into key focus areas and matters for the commission to consider when assessing the market. Views were also presented on the expected outcomes of the retail energy market and what it should deliver for customers. There was general

1. Developing a framework and approach

support for the use of the SCP framework as a starting point for the commission, but to supplement the framework with measures that focussed on the experience of customers.

Stakeholder feedback

Following the presentations and panel sessions, stakeholder attendees at the forum were placed into groups and asked to list their top five indicators of a competitive and efficient market, using both the traditional economic indicators and a customer perspective. Stakeholders agreed that it is important for the commission to conduct an assessment based on metrics, and to measure various indicators over time to get an idea of how competition is working while recognising imperfections and the dynamic nature of the competitive market.

The following indicators were represented the most in discussions with stakeholders:

- **Customer engagement:** this was the most represented indicator identified by attendees. These indicators would aim to reveal how customers view their retailers, how satisfied customers were in terms of value for money, and how retailers deal with complaints. Stakeholders stressed the importance of understanding more deeply human behaviour when customers engage with the retail energy market.
- **Customers experiencing vulnerability:** stakeholders want to know how well retailers are engaging with customers who are experiencing vulnerability. This includes some commentary on how effective the payment difficulty framework has been for customers, and whether customers facing vulnerability are accessing good deals in the market.
- **Affordability:** how easy is it for customers to pay their energy bills, particularly when prices are rising and at this time of very low wage growth. Although it would not be a measure of how competitive the market is, it was acknowledged that it would assist in policy decisions around government assistance.
- **Market share:** an indicator that is used widely, this was also very popular among stakeholders who wanted the commission to report on how many retailers are in the market and the concentration of the market.
- **Retail margins:** stakeholders also want the commission to measure this well used indicator, including a look at margins over time and some assessment as to whether the margins being earned by retailers are reasonable.
- **Price dispersion:** stakeholders want the commission to measure the range of prices that are in the market, which was the subject of some discussion during the first session of the forum. They also want this indicator to look at how prices are set relative to the Victorian Default Offer and whether the range of prices reflect different service offerings by retailers.

- **Product and service differentiation:** how many products are offered by retailers and how are they different in terms of value to the customer. There should also be a measure that indicates how innovative retailers are being when it comes to offers/products in the market.
- **Switching rates:** a well-used indicator, stakeholders want the commission to delve into the reasons customers switch retailers, as well as how easy it is to switch.

Supporting these indicators, stakeholders suggested the commission continue to focus on customer outcomes, and consider appropriate customer segments that may distinguish between customers who are engaged or disengaged; by location; or by income etc. There should be reporting on what customers are paying compared to the best deals that are being offered by their retailer.

Some stakeholders also suggested that the review should focus on what the retailer can control. There should be an examination of how recent and prospective changes in the market are impacting outcomes for customers.

Public consultation

The commission has also undertaken further consultation by using the Victorian government's Engage Victoria website.¹² We have asked people for their views on the Victorian energy market, by asking them to share their experiences with us. There was an opportunity for people to leave us their general comments by answering the following question:

“What are the most important factors the commission should consider when assessing the competitiveness and efficiency of the Victorian retail energy market?”

We received nine submissions from the public, with most of those submissions suggesting the most important factor was ensuring that the prices offered by retailers are transparent and easy to understand and compare. Other factors raised in submissions included the level of pricing, particularly for customers who may be experiencing payment difficulty, the profits being earned by retailers, the value that retailers add to the energy market and the level of foreign ownership.

¹² <https://engage.vic.gov.au/assessing-energy-retail-markets-competitiveness-and-efficiency>

Summary of stakeholder views

The consultation undertaken by the commission to obtain the views of experts and other interested stakeholders has provided some valuable insights. The key areas that the feedback has suggested the commission consider when developing its framework are:

- The SCP framework is a good starting point when considering how competitive and efficient the energy market is.
- No one indicator, or category of indicators, should be used in the commission's assessment, rather a more multifaceted approach should be employed.
- There needs to be more of a focus on the customer experience, particularly with regard to the pricing strategies of retailers.
- Careful consideration should be given to how the energy market is working for vulnerable customers.

2. Victorian customer outcomes from the retail energy market

As an economic regulator, we expect to see competition provide positive long-term outcomes for Victorian consumers. We now have a function to monitor and assess the competitiveness and efficiency of the Victorian energy retail market,¹³ and at the same time we are to perform this function in a manner that promotes the long-term interests of all Victorian consumers.¹⁴

However, we recognise that a fully competitive and efficient market may not result in positive long-term outcomes for all Victorian consumers. It is more likely that a fully efficient market would result in outcomes that could be for the benefit of certain customers at the expense of others.

In this chapter, we describe the outcomes that we would expect a Victorian energy retail market to deliver for customers. We also set out whether a perfectly competitive and efficient market could deliver these outcomes, and how recent reviews and inquiries have considered the Victorian energy retail market.

What outcomes should we expect for Victorian energy customers?

As the economic regulator for essential services such as energy, we consider our objectives when considering outcomes that promote the long-term interests of Victorian consumers. We also consider a range of matters such as:¹⁵

- price, quality and reliability
- efficiency, incentives for long term investment, financial viability, and the scope of competition for industry
- gains from competition and efficiency for consumers (including low income and vulnerable consumers) and regulated entities.

Considering our objectives, we would desire a retail energy market that would maximise the possible gains and benefits from competition that would lead to reasonable prices and service quality for all Victorian consumers.¹⁶ This would mean that retailers in the market are operating as

¹³ Essential Services Commission Act 2001, S. 10AAB.

¹⁴ Essential Services Commission Act 2001, S. 1.

¹⁵ Essential Services Commission Act 2001, S. 8(1-2), 8A.

¹⁶ Electricity Industry Act 2001, s10(b), Gas Industry Act 2001, s18(b)

3. A framework to measure competitiveness and efficiency of the market

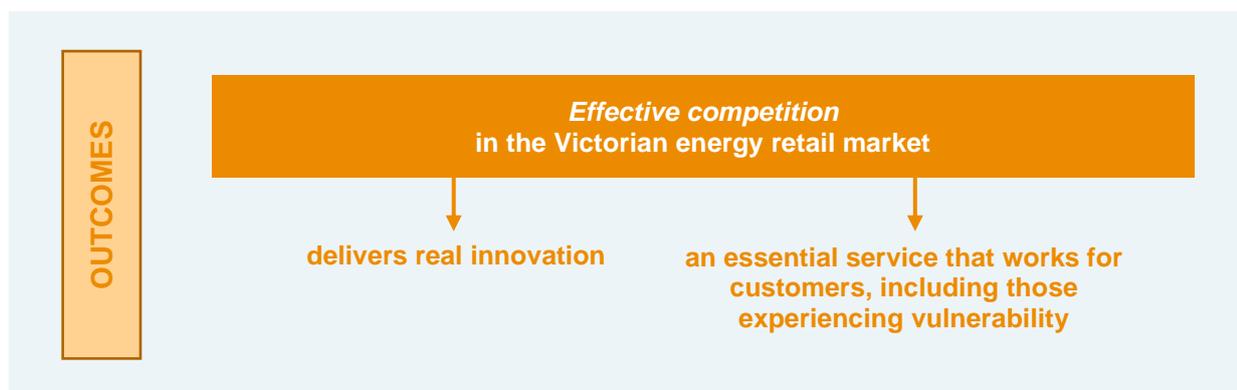
efficiently as possible, and would likely demonstrate real innovation that either reduces industry costs or better matches customer preferences.

Such a market may be one where customers have confidence in finding the best energy deal appropriate for them. Customers should face reasonable simplicity in the choice of products most suitable to them, and the ability to change retailers and energy offers would be straight-forward and seamless. Customers would be satisfied by the service provided to them from retailers. Customers would also be confident that the prices they are paying reflect the value they are getting from these energy services.

However, we would not desire for some customers to experience unreasonable detriment at the expense of the gains from competition, particularly as energy is an essential service. This may be particularly the case for customers experiencing vulnerability, such as those anticipating or facing payment difficulty, or those who might struggle to confidently engage in the market for varying reasons. Our objectives under the industry acts also note our role in promoting protections for customers, including those who are facing or experiencing payment difficulty.¹⁷

We are looking for competition in the market that delivers positive long-term outcomes for Victorian consumers – a market with effective competition.

Figure 4 Outcomes we expect for Victorian energy customers



A market for an essential service that serves all customers, including those experiencing vulnerability

We think that it is important to recognise energy as an essential service when considering competitiveness and efficiency in the market. There are three factors that we believe make energy an essential service:

¹⁷ Electricity Industry Act 2001, s10(c), Gas Industry Act 2001, s18(c)

- most customers cannot exit the market
- there is no fully substitutable product or service for customers
- customers rely on the service

The essentiality of energy means that we expect all Victorian consumers to be able to have access to reasonably priced energy, and there should not be unnecessary barriers to access it. Therefore, the market must serve all customers including those experiencing vulnerability.

Can a highly competitive and efficient market deliver the desired outcomes?

Following the completion of the Hilmer Review¹⁸, Victoria became the first Australian jurisdiction to initiate steps towards full retail competition in 1994. Legislation and regulations were developed that opened retail competition in electricity progressively to groups of customers between 1995 and 2001.¹⁹ In 1997, Victoria began opening up competition to the gas market.

It was expected that the introduction of full retail competition in the energy market would deliver the outcomes described in the previous section for most Victorian consumers. The basis upon which this expectation was formed is founded in the economic theory of competition and how it enables producers and consumers to benefit from the competitive process.

A highly competitive market will deliver positive outcomes for customers because there is genuine and vigorous rivalry between retailers. This rivalry exists because customers exercise their ability to choose the retailer that provides them with the service they want. Customers find it easy to shop around and retailers must consider this when developing their service offerings.

In a highly competitive and efficient market, retailers will always be seeking to gain an advantage over their competitors. This results in retailers being keen to innovate in order to gain that advantage. Retailers need to do this because in a highly competitive market they are unable to charge higher prices than their competitors, because customers will simply choose to sign up with the retailer offering the lowest price. Retailers know that if they do not continually look for the most efficient way to provide their services, they will lose market share and therefore shareholder value.

The degree to which competition would provide the same benefits to vulnerable customers is less clear. As described earlier, it is important to acknowledge that as an essential service, it is imperative that all customers experience positive outcomes. Where there is uncertainty as to

¹⁸ COAG Communique 19 August 1994, *The National Competition Policy Review* (The Hilmer Review), 1993

¹⁹ See section 25 of the *Electricity Industry (Amendment Act) 1994*, and the *Electricity Industry (Non-Franchise Customer) Regulations 1994*.

whether a highly competitive and efficient market can deliver positive outcomes for all customers, other protections may be warranted.

The Victorian energy market has failed to deliver the desired outcomes for customers

Since opening to competition there have been several reviews, including those undertaken by the commission and its predecessor – the Office of the Regulator General.

More recently, the Victorian government and federal agencies have undertaken their own reviews into the effectiveness of competition in the retail energy market. We have examined the most recent reviews – the Independent Review of the Electricity and Gas Retail Markets in Victoria (independent review), the Australian Competition and Consumer Commission’s (ACCC) inquiry and the Australian Energy Market Commission’s (AEMC) 2018 competition review – which have informed us of the different approaches used by these agencies.

Additionally, the commission has been reporting on the price and service performance of energy retailers for many years, most notably in its Victorian Energy Market Reports since 2016-17. The data in these reports also provide further context into our on-going role in reviewing the market.

Independent Review of the Electricity and Gas Retail Markets in Victoria (2017)

The independent review found the prices being paid by Victorian consumers were unusually high and concluded that a failure of the market contributed to this outcome. The independent review suggested three main factors led to this market failure:²⁰

- **The cost of competition has continued to increase:** The independent review concluded the additional costs of competition that had been introduced since the market was deregulated have not been offset by lower overall retail costs or other benefits to consumers. It appears that as competition developed, and customers sought out better offers, retailers spent even more on acquiring and retaining customers, which is a potentially inefficient outcome. A large part of these higher costs were passed on to consumers in the form of continually higher retail prices.
- **The structure of the market:** The market has three large tier one retailers²¹, four medium tier two retailers and around 20 small tier three retailers. The independent review found tier one retailers have significant market advantages over their competitors, due to their pre-existing customer bases and established systems. Despite these advantages they tend to price at the

²⁰ Independent Review Panel, 2017, *Independent Review of the Electricity and Gas Retail Markets in Victoria*, August 2017, p.ix

²¹ Tier 1 retailers include: AGL, Energy Australia and Origin Energy.

upper end of the price range. The independent review suggested that it appears these retailers did not face the competitive tensions that might be expected in a well-established competitive market.

- **The practices of the industry:** The independent review observed that the actions of energy retailers were resulting in customers finding it increasingly difficult to navigate the market. They considered retailers offered what appear to be simple discounts on energy prices; however, it is often difficult for customers to understand exactly what they would be expected to pay. This is because the base prices against which discounts are applied vary across retailers. It is often the case that high discounts are not as cheap as lower or undiscounted offers.

ACCC Retail Electricity Pricing Inquiry (2018)

The ACCC undertook a broad review into the electricity market. Whilst the ACCC's review was focussed on the retail markets, the terms of reference also required the ACCC to consider the operation and competitiveness of the wholesale electricity market to the extent that it affects retail market outcomes.

The ACCC have broad information gathering powers and used these to collect data from market participants. This included cost data, price data, discounting data, and internal documents. The data collected enabled a much deeper identification and analysis of the issues that may be inhibiting effective competition.

With this information, the final report made 54 recommendations including 20 under the heading *Improving consumer experiences and outcomes*. Many of these recommendations are a result of observed competitive behaviour that is not producing desirable outcomes for consumers.

The ACCC's inquiry highlighted several concerns in the retail energy market. This included:

- Confusion around discounting practices, particularly the difficulty customers face in finding the best offer or what they will actually pay. Conditional discounts also bore little relation to the costs incurred by retailers and were likely to pose equity issues for customers facing payment difficulty.
- Concerns that third-party intermediaries are not acting in the best interest of consumers and may add to market complexity.
- Analysis that suggested standard retail contracts were no longer fit for purpose and their pricing appeared to only relate to discount size.

AEMC's Retail Energy Competition Review

The Australian Energy Market Commission (AEMC) undertakes an annual competition review of the retail electricity and gas markets across Australia under terms of reference issued by the Council of Australian Governments (COAG) Energy Council. Each jurisdiction introduced

3. A framework to measure competitiveness and efficiency of the market

competition and deregulated prices at different points in time, with Victoria being the first mover nationally.

The AEMC considers a number of typical measures relating to market structure, conduct and performance. The reviews rely heavily on publicly and self-reported data and information. The AEMC do undertake retailer interviews to help frame the narrative of their report.

The 2019 review identified that across the NEM, electricity offers and the associated discounting practices are confusing for consumers, and that the act of leaving often results in a better deal.²² Price decreases were observed between 2018 and 2019 and were largely driven by lower prices being offered by new and emerging retailers.

Prior to the 2018 review, the AEMC had not identified any characteristics of the market that would be in conflict with competition. These predominately supply-side indicators were informed by (as per the terms of reference) the use of publicly available information and the use of generally available offers limits the ability to delve deeper into different market characteristics as the ACCC has been able to in its inquiry.

Victorian Energy Market Report

Since 2016-17, the commission has also reported on the retail energy market through our annual Victorian Energy Market Report and regular updates. These reports largely focus on the energy prices offered by retailers, their performance in terms of service quality (such as complaint levels and assistance for customers in payment difficulty) and compliance against the energy rules. These performance reports aim to provide transparency on retailer behaviour in the market.

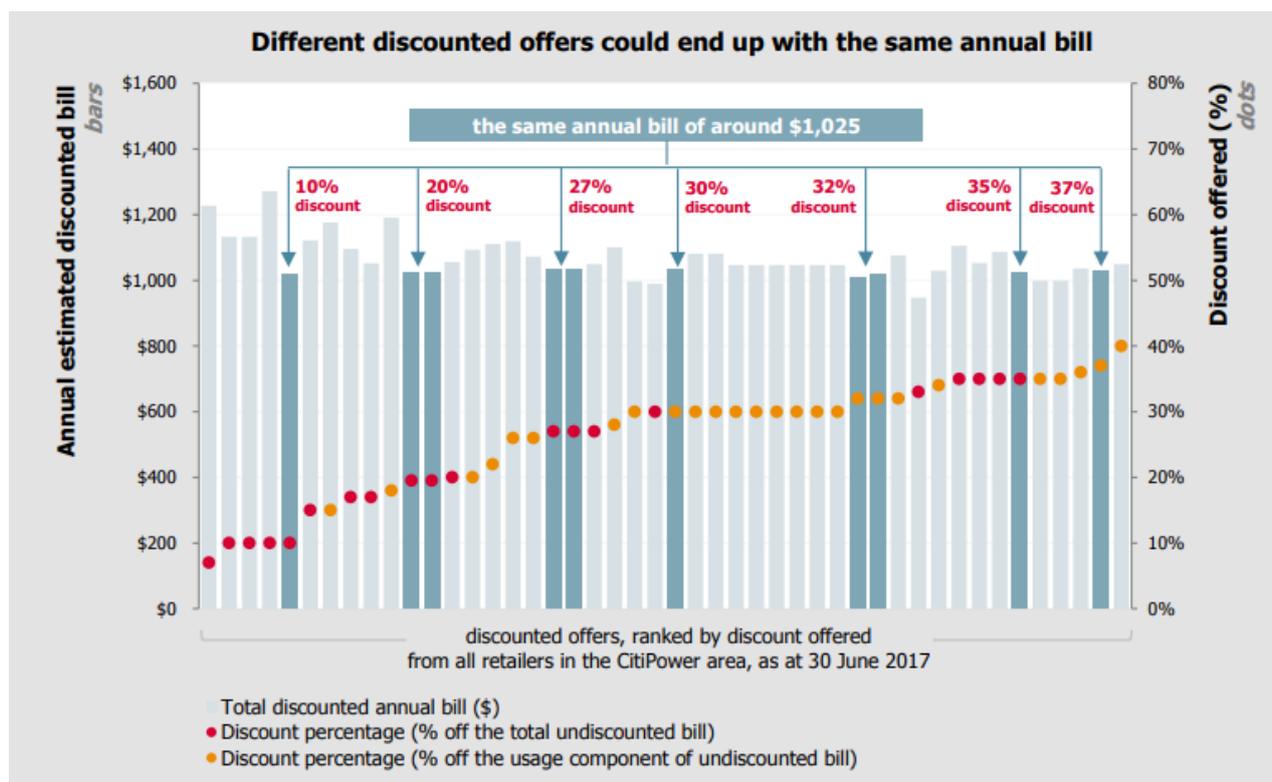
For example, in September 2017 we released an update report that observed how discounting practices could lead to confusion for customers (shown by figure 5).²³

²² AEMC, 2019, *2019 Retail Energy Competition Review, Final Report*, 28 June 2019.

²³ Essential Services Commission, 2016, *Victorian energy market update: April to June 2017 with audit findings*, 26 September 2017

3. A framework to measure competitiveness and efficiency of the market

Figure 5 A comparison of the estimated prices of electricity offers by discount percentages in 2017



More recently in November 2019, we reported on the amount Victorian customers actually paid to their electricity retailers throughout 2017–18 and 2018–19. This provided direct insight into the amount paid by customers, and the type of contracts customers were currently receiving.

We found that 16 per cent of customers on discounted electricity market offers failed to meet some or all the conditions to receive their discounts – leading to an average cost of \$188 for an annual electricity bill. These findings helped inform the commission’s proposed rules to cap conditional pay-on-time discounts. This type of analysis marked the beginning of our monitoring and reporting of the market from a perspective of competitiveness and efficiency, as we published in our Victorian Energy Market Report 2018-19.²⁴

We aim to continue enhancing our reporting and analysis to inform our regulatory reforms and assist policy makers in their considerations.

²⁴ Essential Services Commission, 2019, *Victorian Energy Market Report 2018-19*, 29 November 2019

3. A framework to measure competitiveness and efficiency of the market

3. A framework to measure competitiveness and efficiency of the market

Traditional frameworks to measure competition and efficiency of markets

A traditional framework to assess competition and efficiency within various markets is the 'structure, conduct and performance' framework (SCP framework). The SCP framework has been used in several other reviews when assessing the energy market. This approach examines a range of indicators along with any trends over time to provide an insight into how the market is performing. The SCP framework generally involves an examination of the following:

- **Market structure** – what does the market look like? The analysis tends to focus on the number of retailers and the level of market concentration. Other factors considered are the ease of entry, expansion and exit to the market. The number and types of consumers, as well as the demand they each have for energy is also observed.
- **Market conduct** – how are both retailers and consumers behaving in the market? When looking at retailers, the indicators usually examine the product and pricing strategies employed. For consumers, conduct typically relates to how consumers engage in the market, such as switching rates and how many customers are on standing offers (now the Victorian Default Offer) versus market offers.
- **Market performance** – what are the overall outcomes that the market is delivering for retailers and customers? For consumers, this looks at the level of customer satisfaction, as well as the level of complaints and disconnections. For retailers, it involves examining retail margins as a measure of profitability.

The SCP framework has traditionally been applied in a linear fashion, as follows:

Structure → Conduct → Performance

But we know that markets such as the Victorian retail energy market have not developed in such a straightforward way. These three aspects relate and depend on each other in a more complex relationship. For example, the 'performance' of retailers will impact on 'structure' (when the market is profitable new retailers will enter the market), as well as impacting on 'conduct' (customers who experience very low levels of satisfaction may leave the market and seek other technologies) – which would in turn impact 'structure'.

While the commission believes there is value from this approach, the feedback from stakeholders suggests that it may not provide sufficient focus on the outcomes received by customers. The

commission proposes a slightly amended framework that builds on the SCP framework but draws out in a very specific way how retailers and customers interact in the market.

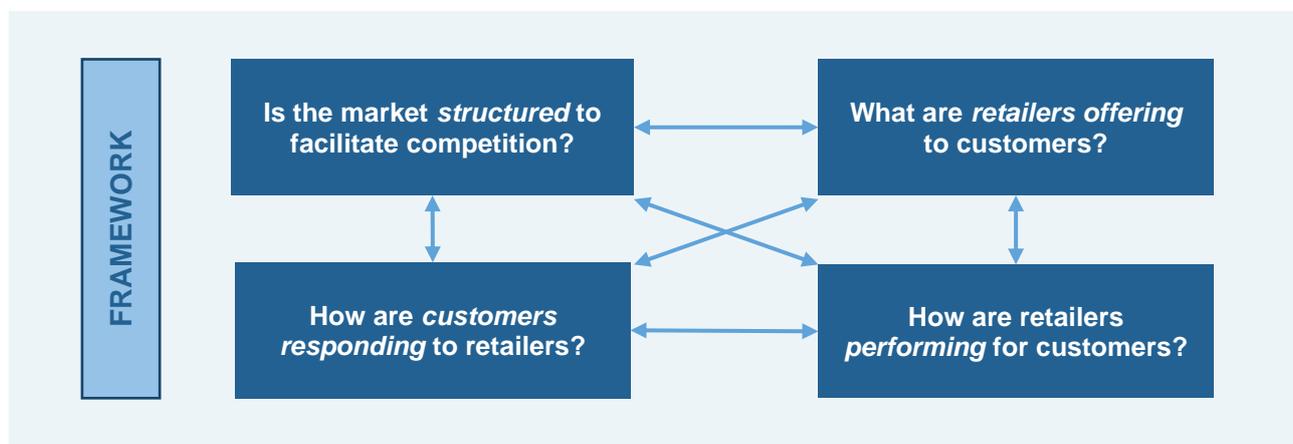
An adapted framework to measuring competition and efficiency

The commission's proposed framework seeks to capture the following questions:

- Is the market structured to facilitate competition?
- What are retailers offering to customers in the market?
- How are customers responding to the market?
- How are retailers performing for customers?

This section expands on our proposed framework as illustrated below.

Figure 6 Our framework for assessing the energy market



Is the market structured to facilitate competition and efficiency?

This question examines the structure of the market and provides a view as to whether the factors give rise to a competitive and efficient market. The indicators used in the market structure of the SCP framework will be used to answer this question. Data from this analysis will enable the commission to understand if effective competition is possible in the energy market but will not be used to solely assess how competitive and efficient the market is.

We are conscious not to take a simplistic view of market structure in our assessment. For example, the number of participants in a market has been a popular indicator of competition – participants could also be referred to as competitors. However, some economists consider that while many competitors might indicate a degree of competition in a market, it may not suggest increased

efficiency.²⁵ Other economists have also noted the comparison between Australian telecommunication markets and energy markets. Despite high levels of market concentration in telecommunication, that market has been seen as more competitive than retail energy markets.²⁶

When considering market structure, the simple number of energy retailers may not be the most reliable indicator. It may be appropriate to consider other factors, such as the differentiating characteristics of the participants in the market, which might include the different target markets or business models of energy retailers.

Stakeholder question: What other factors should we consider when examining the structure of the market, beyond considering the number of participants in the market? Should there be defining and differentiating characteristics between participants in the market?

What are retailers offering to customers in the market?

We aim to consider the way retailers are making energy offers to customers. Information on the pricing practices of retailers will be captured under this question. This will include the range of prices made available to customers, how these compare to other market offers from competitors, as well as to the Victorian Default Offer (VDO).

We recognise there are a range of methods in considering retail pricing in the market. Several reviews have focused on the level of price dispersion in the retail energy market. However, price dispersion in imperfect markets could simply be an outcome of price discrimination by retailers. Price discrimination could be used to confuse customers and prevent customer switching, which is not an efficient or competitive outcome for a market and fails to deliver customer outcomes.

We are also particularly interested in the actual types of products and prices customers are currently contracted with retailers. More recently, the commission used its powers to compel electricity retailers to provide information on the amount paid by customers for energy. We are interested in continuing this analysis, and to compare the actual type of offers people on compared to what is offered in the market. This type of analysis may reveal the value (or potential lack of value) in the differentiation of energy products from retailers.

²⁵ Price, D (Frontier Economics), 2019, *A framework – paper for the Essential Services Commission*, p 2.

²⁶ Deloitte, 2019, *Economic views on assessing competitiveness and efficiency of the Victorian retail energy market*, p 9-10.

The commission is also interested in carefully examining any signs of innovation in terms of the new products being offered by retailers, as this may signal possible opportunities to reduce costs for the industry in the long-run.

Stakeholder question: When examining the range of prices being offered by retailers, what other factors should we consider when assessing the competitiveness and efficiency of the Victorian energy market?

How are customers responding to the market?

A key objective of the commission is to consider how the market is delivering outcomes for Victorian energy customers. In our assessment, we are particularly interested in how customers are responding to retailer offers and services. We will capture data and information including simple rates of switching by customers, the number of customers on market offers, and the actual prices being paid by customers.

We are also particularly interested in how customers are responding to new requirements for Victorian retailers, such as the information on bills revealing the retailers' best offer, and how prices are marketed and advertised (particularly for electricity offers with reference to the VDO price). The commission has also undertaken several behavioural insight studies to inform its regulatory reforms, particularly related to best offer and reference price reforms.

The analysis and learnings from behavioural insight studies will continue to inform the way we understand how Victorian customers are responding to the retail energy market, and these will be an ongoing feature of our reporting framework.

It will also be vital to gain a better understanding of why customers are making decisions in the market. We recognise the importance of not assuming consumers will make the best decision based on clear and accurate information presented to them. In imperfect markets, consumers have various preferences, biases and external factors that impact their decision-making.

Stakeholder question: What factors should we consider in understanding how customers interact with the market? What level of engagement should be expected of customers in the retail energy market?

3. A framework to measure competitiveness and efficiency of the market

How are retailers performing for customers?

We currently collect information and report on indicators of performance by energy retailers, namely through our Victorian energy market report and updates. We have reported on performance indicators relating to complaint numbers, disconnection levels, levels of arrears, extent of retailer assistance to customers experiencing payment difficulty, and retailer compliance history against the energy rules. We seek to continue reporting on these performance indicators and expand on these where relevant. This may include collecting information on retail profit margins or conducting surveys into the level of customer satisfaction and engagement with retailers.

Information on the type and extent of performance and compliance indicators we collect from energy retailers is set out in our Compliance and Performance Reporting Guideline.²⁷

Comparing against a competitive and efficient retail energy market

We recognise that a fully efficient market is a theoretical concept. Most markets will have elements of a fully efficient market but have shortcomings in other aspects. In assessing for competitiveness and efficiency, we will identify the potential gap between our Victorian energy retail market and a theoretically efficient market.

In economic terms, the factors that result in this gap indicate that there are failures in the market. Each factor on its own may not indicate a complete failure in a market but may be symptoms of reduced competition or efficiency in the market. We will actively seek to identify and test the presence of the symptoms that may indicate the potential gaps between the current market and one that delivers better outcomes for customers. Collectively these symptoms may also require further analysis and regulatory intervention if warranted.

²⁷ Accessible at <https://www.esc.vic.gov.au/electricity-and-gas/electricity-and-gas-codes-guidelines-policies-and-manuals/compliance-and-performance-reporting-guideline>

4. Our approach to analysing the Victorian retail energy market

The commission will need to understand how each of the different components of its framework interact with and influence each other in order to assess the competitiveness of the market. Due to this complexity in the market, we will adopt a 'systems thinking' approach.

It will be important to understand the reasons why the customer experience is falling short of what is desired. In order to do this the commission will actively seek quantitative and qualitative data to assist us in gaining this understanding. This will then allow the commission to better inform itself and policy makers on the most appropriate changes to policy or regulations.

A robust 'systems thinking' approach based on evidence

Robust systems thinking will require the commission to use a more scientific and evidence-based approach when assessing the energy market. One way in which to undertake this will be to test a series of hypotheses. These can then be empirically tested to either support or deny these hypotheses. This approach will enable the commission to avoid the possibility of confirmation bias when we draw conclusions, a criticism that has sometimes been directed at the approach used under the traditional structure, conduct and performance framework.

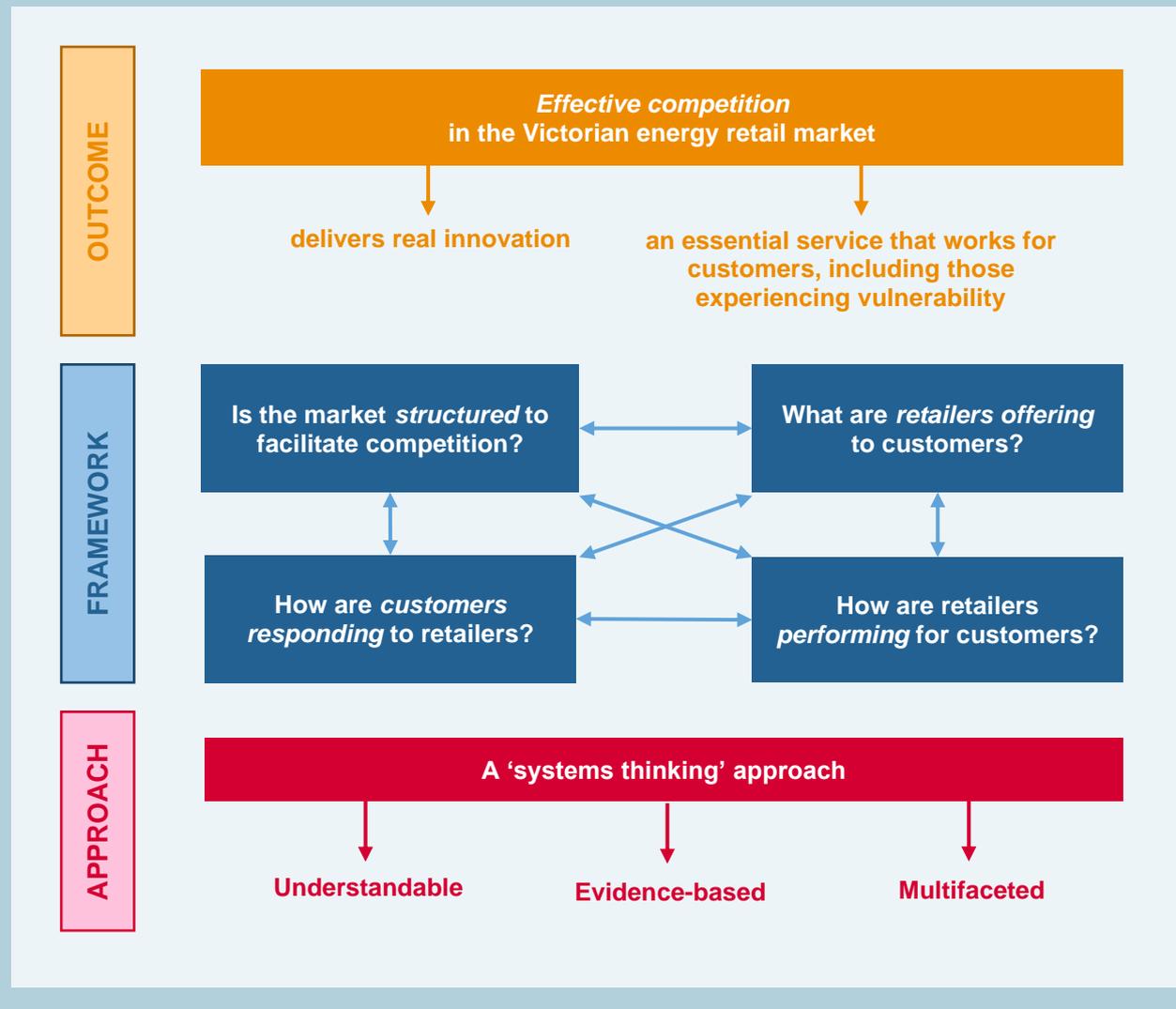
When undertaking our assessment, the commission believes that the following approach will result in a report that is sufficiently robust and useful for all stakeholders:

- **Understandable:** stakeholders will be able to clearly see how we have used the framework and how this has led to our assessment of the market and any recommendations within
- **Evidence-based:** the framework will be underpinned by quantitative and qualitative data for our indicators as well as robust analysis of the insights they provide
- **Multifaceted:** we will not rely on a single indicator or any group of indicators to assess the competitiveness and efficiency of the market. Instead we will analyse the indicators and understand and explain how they interact with each other.

The commission must also recognise markets evolve over time, sometimes at a rapid pace. This means that it is possible that an indicator may not necessarily draw out the same type of conclusions over time. It will be important for the commission to continually consider the context in which each of the indicators is used in the assessment process. This means that there may be limitations in conducting longitudinal studies (despite their usefulness), and we must understand these when conducting our assessment.

Summary of our framework and approach

The diagram below illustrates the framework and approach the commission will use to assess the competitiveness and efficiency of the Victorian energy retail market.



4. Our approach to analysing the Victorian retail energy market

5. Our first report

The commission will continue monitoring the market in 2020, with an expanded role consistent with the framework and approach proposed in this report. In producing our first report assessing competition and efficiency, we are mindful of achieving the following:

- The report will describe the degree of competitiveness and efficiency of the Victorian energy market.
- The report will continue to provide information on the performance retailers (based on data provided to us and what we collect), and the prices of energy offers available in the market.
- The report will demonstrate our monitoring of the market, which will provide the commission with a better understanding of how the energy market, in its current structure, is delivering outcomes for customers.

To inform our first report, we will be engaging extensively with stakeholders to understand the customer experience as well as retailer conduct in the market. We will also aim for our analysis to be underpinned by robust evidence, and where appropriate may use our information gathering powers to understand the costs and practices of businesses in the retail energy market.

We also intend to provide insights to inform policy makers and our own regulatory reform program on an on-going basis. As is the aim of all our reporting, we seek to provide useful and valuable insights for all our stakeholders so that:

- customers can read the report and have confidence in the market working in their best interests
- policy makers can use our report to consider what amendments may be needed to improve the outcomes of the market, particularly in areas where there is potential market failure and
- retailers would be able to understand how their actions in the market will influence our assessment, and therefore the impact that may have on policy changes.

Since 2016-17, we have been reporting on the market through our Victorian Energy Market Report and updates. We intend for our assessment on the competitiveness and efficiency of the retail energy market to be published as the Victorian Energy Market Report 2019-20. We will also continue to provide regular updates of data and retailer performance through our Victorian energy market updates, which are published in March, June and September each year.

4. Our approach to analysing the Victorian retail energy market

Focus for our first report

During our consultation, stakeholders expressed a firm view as to some of the symptoms that have led to a gap between what outcomes are being delivered by the current Victorian energy market and the outcomes we want for consumers from effective competition. Two key reasons identified by our stakeholders were:

- Limited signs of genuine innovation
- Low levels of customer trust

In our first report we will actively seek to identify and test the presence of these factors and better understand why the shortcomings exist.

Limited signs of genuine innovation

Genuine innovation (on both the demand and supply side) should result in better outcomes for consumers whether it be from new products or a step change reduction in costs.

It has been argued that the presence of innovation in a market should result in positive outcomes for customers in the long-run. In theory, genuine innovation in markets should result in lower costs for suppliers or improved product or service quality for customers.

The term innovation is regularly applied to the retail energy market, for example, to characterise new types of retail offers that are introduced into the market. However, we are interested in identifying what genuine innovation would look like in Victoria's retail energy market, and these could lie on a spectrum.

What is an 'innovative' retail energy offer?

There are several retail energy products and services have been characterised as being innovative in the market, for example:

- Aggregation of customer generation assets to provide greater financial benefit to a customer, perhaps via virtual power plants
- Demand management offerings that provide services to customer to better manage energy use or costs at certain times
- Electricity offers with rates that track with the wholesale price of energy
- Subscription-based energy offers, i.e. offers with a flat monthly fee as opposed to the conventional supply charge and usage rate structures
- Bundled product offerings, such as energy retail products being bundled with telephone, internet or battery storage products

4. Our approach to analysing the Victorian retail energy market

These products and services could represent a range of innovation – that is, some products and services represent greater signs of innovation than others. It has been argued that in Victoria, genuine innovation in retail energy markets would be customer-focused and would address some of the negative outcomes faced by customers, such as:²⁸

- reducing confusion and building the confidence of customers in making decisions that lead to an energy contract that is most suitable to them
- increased affordability by helping customers manage and optimise energy consumption and
- retail products (or the structure of rates or products) and service offerings that better align with the preferences of customers.

We also question whether some of these retail energy products are simply a way for retailers to differentiate their product in the market. For example, the emergence of percentage discounts for retail energy offers was first seen as a sign of innovation in the market. The evolving practice of discounting in the market resulted in increased confusion and complexity in customers choosing the most appropriate energy plans. Some customers have even chosen discounted offers that made themselves worse-off, or they ended up not choosing the lowest priced offers available in the market at that time. It is debatable whether these practices led to increased efficiency in the market, rather than adding search costs for customers.

Innovation, by definition, is difficult to identify or predict by its very nature. However, one can observe the market for the presence of products and services that appear to be a signal of innovation for the industry.

We consider that genuine innovation in the retail energy market should result in either a decrease in industry costs, or an increased alignment with customer preferences and expectations in the long-term.

We are also aware that genuine innovation could also exist outside of the traditional energy retailers, such as aggregators or new technology companies. These types of new and emerging business models could even act as disruptors to the retail energy market, and could provide value for customers in the long-term.

We will also need to regularly monitor innovation over time to identify new and emerging energy products or services, and to understand whether the regulatory framework is fostering or hindering

²⁸ Deloitte, 2019, *Economic views on assessing competitiveness and efficiency of the Victorian retail energy market*, p 10-11.

innovation in the retail energy market. In conducting our analysis, it may be appropriate to test whether genuine innovation can be found in the retail energy market. If innovation is not present, we may consider the reasons why the market is not supporting innovation, based on our proposed framework.

Stakeholder question: What have you observed as an indicator of innovation in the retail energy market? Provide examples and explain why it is a sign of innovation.

Low levels of customer trust

Trust ought to be present for the market to be effective for all customers, particularly customers experiencing vulnerability.

The concept of trust in markets is a contested area of discourse between stakeholders, particularly from an economic perspective. However, under our framework for review, we consider that the levels of trust in the market is evident by the conduct we see from both the supply and demand-side. That is, when assessing conduct in the Victorian energy retail market, we ought to consider the following:

- **Customer perspectives.** This will seek to understand perspectives and sentiment from customers. It is important to understand whether the market is working in the interests of consumers, and to test whether the products and service offered by the market is aligned with customer expectations.

However, a market to deliver for all consumers is unattainable. So, it is important to consider for which customers is the current market working well for, and for whom it does not work well for. This is becoming widely recognised in economic theory – that customers represent a diverse range of groups and segments that may have different preferences or ability to participate in such a market. Through our early consultation with stakeholders, we understand that Victorian customers participating in the energy retail market are varied, such as those who are engaged and disengaged, those that may experience or are anticipating payment difficulty, or customers experiencing vulnerability.

It is important to recognise that a fully competitive and efficient market will not be to the benefit of every single consumer – there are limits to which a competitive market can work for all consumers. Recognising this, we seek to identify areas of the market that may not be of the benefit for segments of the market. This could inform areas of reform or policy to which competition, as a tool, cannot address. Likewise, we can consider how existing regulation and policy are interacting with these customers.

4. Our approach to analysing the Victorian retail energy market

- **Retailer conduct.** On the supply side, understanding how suppliers are delivering its products and services should arguably match the needs of customers. It is understandable that this conduct could conflict from the motives of businesses to act in ways that maximise its profits. A further question would be whether these profits reflect efficient behaviour or are a result of supplier conduct that extracts further value for certain cohorts of customers. The extent to which this occurs in the market is an important one.

There is a unique relationship between supplier conduct and the expectation of customers - together these can indicate levels of trust in the market. For example, widespread behaviour of misconduct or non-compliance with regulatory obligations can reduce levels of trust in the market, not only for consumers but for government, policy makers and the regulator. Similarly, suppliers could display practices that appear to be reflective of product differentiation but could act in ways that confuse customers in making (or not making) optimal decisions. One example of this is through the discounting behaviour in the energy market, where large percentage discounts were made off different retailer base rates, making these discounts difficult for customers to rationally compare across the market.

Considering both the effect of retailer conduct and an understanding of customer perspectives can work in tandem to indicate levels of trust in the market.

Stakeholder question: What questions would you ask Victorian customers to understand their levels of trust in the retail energy market? Be as specific as possible and provide reasoning for your suggested questions.

6. Seeking stakeholder views and insights

This report outlines the commission's intended framework and approach into reviewing the competitiveness and efficiency of the Victorian energy retail market, utilising a consultative approach based on views from economic experts as well as stakeholders.

The commission is open to further comments and views from stakeholders to enhance our framework and approach, or to suggest areas of focus for our first report. Throughout the report, we posed several questions for stakeholders to consider.

Stakeholder questions are summarised below:

1. What other specific sub-markets should we consider in our assessment, particularly those that are different to the traditional model of energy retailing?
2. What other factors should we consider when examining the structure of the market, beyond considering the number of participants in the market? Should there be defining and differentiating characteristics between participants in the market?
3. When examining the range of prices being offered by retailers, what other factors should we consider when assessing the competitiveness and efficiency of the Victorian energy market?
4. What factors should we consider in understanding how customers interact with the market? What level of engagement should be expected of customers in the retail energy market?
5. What have you observed as an indicator of innovation in the retail energy market? Provide examples and explain why it is a sign of innovation.
6. What questions would you ask Victorian customers to understand their levels of trust in the retail energy market? Be as specific as possible and provide reasoning for your suggested questions.

Stakeholders are not limited to answering these questions but answering these specific questions will be useful for the commission as it continues its monitoring and analysing of the market.

How to contribute to our review

We will continue to consult with interested stakeholders and invite you to contribute your views by making a submission in response to our framework and approach. We will be accepting formal submissions to our review until **30 March 2020**.

5. Seeking stakeholder views and insights

To make a submission on this paper please go to Engage Victoria's website:

<https://engage.vic.gov.au/>.

Submissions can also be sent by mail to:

Submission to 'framework and approach: assessing the competitiveness and efficiency of the Victorian energy retail market' consultation
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne, Victoria 3000

To promote an open and transparent decision making process, all submissions will be made available on the commission's website, except for any information that is commercially sensitive or confidential. Submissions should clearly identify which information is sensitive or confidential.

We will also be in regular contact with our stakeholders through interviews, meetings, workshops and public forums as part of our process. We welcome all stakeholders to be involved in our engagement in the future.

If you have any questions, please contact us on (03) 9032 1300.

Our approach to consultation is set out in our updated Stakeholder Engagement Framework.²⁹

²⁹ Essential Services Commission, Stakeholder engagement framework – Charter of Consultation and Regulatory Practice, June 2018.

5. Seeking stakeholder views and insights

Appendix A: Terms of reference

Efficient pricing in the energy market

Terms of Reference to the Essential Services Commission

The Essential Services Commission (ESC) is requested to conduct a review under section 10(g) of the *Essential Services Commission Act 2001* on the appropriate amendments to the Energy Retail Code to efficiently give effect to recommendations 8A of the Independent Review of the Electricity and Gas Retail Markets in Victoria (the independent review), released on 13 August 2017.

Background

The independent review, commissioned by the Victorian government in November 2016, found the deregulated energy market was not delivering the anticipated benefits to consumers. It made 29 recommendations designed to place consumers back on a level playing field, including changing retailer marketing practices, introducing a Basic Service Offer (BSO) and abolishing standing offer contracts.

In February 2018, the Government provided its support to the recommendations from the independent review, except for two recommendations – introducing a basic service offer and abolishing standing offer contracts (recommendations 1A and 2A). The Government will undertake further analysis on the application and scope of the BSO and abolishing standing offers and their effect on Victoria's energy sector. The Government will consult further with stakeholders regarding the design of a BSO and any alternatives to the BSO.

Request

The Government is now requesting the Commission to give effect to recommendation 8A.

Recommendations 8A requires the Commission to monitor and report on the competitiveness and efficiency of the Victorian energy retail market. The Commission should have the power to compel the provision of any information required to fulfil its functions, including information on costs and margins.

In conducting its review for the purposes of giving effect to recommendation 8A, the Commission is required to have regard to its objectives under the *Essential Services Commission Act 2001*, *Electricity Industry Act 2000*, *Gas Industry Act 2001* and the following:

- findings from the independent review'
- approaches being used by other regulators, including Australian and International regulators; and

- other matters it deems relevant.

In giving effect to recommendation 8A, the Commission is also asked to develop and apply a methodology for determining an efficient price in the energy retail market – a ‘reference BSO price’. A reference price would have the same characteristics as the regulated BSO described by the Independent Review, namely:

- based on the efficient costs to run a retail business;
- includes an allowance for a maximum retail profit margin; and
- must not include customer acquisition costs or headroom.

The Commission is also requested to develop a framework for assessing the competitiveness and efficiency of the Victorian energy retail market, having regard to the matters raised in recommendation 8A.

The Commission is required to complete and publish its review by no later than 31 December 2019.

Unless otherwise determined by Government, the Commission must develop a pricing methodology that could enable the publication of a ‘reference BSO price’ for electricity and gas offers may be published from 1 July 2018.

Consultation

In undertaking this review, the Commission is required to consult widely, including with consumers, consumer advocacy groups, energy businesses, relevant experts, government departments and other regulators.

Reporting

The Commission will provide regular updates to the Minister for Finance and the Minister for Energy, Environment and Climate Change during this review regarding its progress and final approach.