From:	Ron.Ben-David@esc.vic.gov.au
To:	Committee, EC (SEN)
Subject:	ATT: Christin McDonald ==> Re: Senate Environment and Communications References Committee: Inquiry into the performance and management of electricity network companies
Date:	Wednesday, 18 March 2015 5:05:18 PM
Attachments:	Pursuing competitive accountability in retail energy markets (19 March 2013).pdf Promoting the interests (FINAL) (24 May 2013).pdf

Dear Ms McDonald

Thans you for your letter, 24 February 2015, in which you requested information on:

1. why electricity bills in Victoria are on parity with the rest of the country when Victoria has the lowest network costs; and

2. why costs within the Victorian retail sector are higher than the rest of the country when the retail sector appears to be highly competitive.

Due to family circumstance, I have not been able to respond sooner and have not had the opportunity to pull together a formal submission.

However, I have attached two papers that I delivered on these topics in 2013 and the themes addressed remain relevant today. (Note, you may want to just jump to page 19 in the latter paper.)

I also attach a link to our website where you will find the outcomes of our analysis of retail margins, also in 2013.

http://www.esc.vic.gov.au/Energy/Analysis-of-Electricity-Retail-Prices-and-Retail-M/publications

I note that since that time, the AEMC has continued to find higher margins in Victoria as have St Vincent de Paul and Bruce Mountain at CME.

As they say, "If it quacks like a duck, waddles like a duck, then it probably is a duck."

Good luck with your inquiry and I look forward to your findings.

Regards

Ron

Dr Ron Ben-David
Chairperson
Essential Services Commission

Ph: 03 9032 1316
Mob: 0402 096 051
Email: ron.ben-david@esc.vic.gov.au

Pursuing competitive accountability in retail energy markets

Dr Ron Ben-David*
Chairperson
Essential Services Commission

The Essential Services Commission is Victoria's economic regulator. The Commission regulates the Victorian retail energy sector through monitoring and enforcing compliance with licence conditions and Victoria's energy retail codes. In this Paper, Dr Ben-David recounts his experiences in searching for a better electricity contract. He soon turns to a broader reflection on the state of competition in retail electricity markets. Dr Ben-David contends that if opportunities for competition are limited because of the inherent nature of these markets, then the regulatory endeavour must turn to maximising 'competitive accountability'. Namely, the regulatory conditions required to ensure that customers can hold energy retailers to account for the services they provide, the value they create and the value-for-money they have to offer.

Presented at:

Energy 2013 Conference - Sydney (19 March 2013)

* The opinions expressed in this presentation are those of the author alone. They do not represent the views of the Essential Services Commission, its staff or the Victorian Government. The author takes full responsibility for any errors, omissions or conjectures made herein.

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Self-experimentation has played a very important part in the history of science and medicine, among other fields. Some very great, and not so great, discoveries have been made through heroic and often foolhardy individuals using their bodies as physiological canvasses for the advancement of human knowledge. Some are well known to us, others are not so well known.

We all learnt at school about Pierre and Marie Curie who, ultimately, died due to their experimentation with radiation. And many will know the name of Australian Barry Marshall who, in the late 1990s, swallowed a mouth-full of *Helicobacter pylori* in order to demonstrate its role in causing stomach ulcers (as opposed to the then conventional wisdom such ulcers were due to lifestyle factors). Marshall and his colleague Robin Warren, like the Curies before them, went on to win the Nobel Prize.

Not all self-experimentation, however, leads to, or indeed deserves, such acclaim.

In the early nineteenth century, Johann Wilhelm Ritter, (most famous for his discovery of ultraviolet light and electroplating), thought it might be interesting to apply electric current from the recently invented Voltaic pile (an early electric battery) to various parts of his own anatomy. So adventurous, and apparently pleasurable, were some of his self-experiments that he was known to tell people that he intended marrying his voltaic pile.

Later in that century, researchers seem to have become rather fond of gulping down spoonfuls of tapeworm eggs; initially to confirm that ingestion led to infection. It soon became quite the thing-to-do at the University of Basel where researchers would use their intestines as anatomical incubators to cultivate tapeworms up to six feet in length.

And in 1921, the American surgeon Evan O'Neill Kane grew impatient while waiting on a surgical table and decided to conduct an impromptu experiment —

namely, to find out whether it was possible to remove his own appendix. Apparently, it was possible.

So it was within the spirit of this long history of human self-experimentation that I too decided to offer myself to research when I decided to see whether I could find a better energy deal for my household; and I did so with the self-imposed limitation of not using any of my knowledge as the regulator about the different retailers, their offers and their reputations.

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Let me tell you a bit about my household which consists of me, my wife, two teenage daughters and a six year old boy. Our house is about 26 squares and designed to be reasonably energy efficient. We have one TV which is typically watched for less than 2 hours per day but we have computers and iPads and iPods and mobile phones galore. We have a clothes drier but rarely use it and our dishwasher probably gets a run each day. Our heating is gas-fired and we try to avoid over-indulging ourselves with our refrigerated air-conditioner.

We are on single tariff and serviced by one of the 'big three' retailers in Victoria to whom, it seems, we switched from another of the incumbent retailers four years ago. Since that time, we have been inattentive to the available offerings in the market.[1]

In trying to discern our typical energy usage, I was concerned that despite what many websites and sales agents suggest, just looking at the last bill can be very misleading due to seasonal factors, family movements and other household vagaries. Indeed, after digging out four-and-a-half years of electricity bills and plugging all the data into a spreadsheet, I found that our average daily use had varied between 11 and 24 kWh over this period but our long-term use averaged

[1] The only exception being a year and a half ago, when we seem to have added green energy to our purchases to our contract. For the purposes of the analysis presented in this paper, all costs associated with these 'green purchases' have been removed.

at a little over 18 kWh per day — though due to human error, my subsequent research was based on 19.5 kWh per day.

In the four-and-a-half years covered by my research, our tariffs have increased at least once each year, and more recently tariffs have been increased twice per year. Over this period, based on my standardised average daily usage, our typical electricity bill has increased by 86 per cent in nominal terms. That's equivalent to 14 per cent per year.

Although I am reasonably well-versed in the published data on increasing energy prices, I was rather taken aback by these revelations about my own household. Despite a general awareness that our electricity bills were increasing, I simply had not personalised all the publicly available information . . . and that is despite being the regulator responsible for producing some of those public reports!

At this point of my research, self-experimentation and self-interest became a little harder to distinguish.

It is also worth noting that just getting to this stage of my research took me in the order of 5-6 hours of looking for bills, deciphering them, entering all the data into a spreadsheet and manipulating that data into something useful for my research endeavour.

Because I was trying to replicate the experience of a 'typical' customer, I decided that the next phase of my experiment would involve turning to switching sites to see what they had to offer. After some hunting around on the internet, I found about a dozen sites. Of those, 2-3 required my contact details so one of their representatives could contact me in order to discuss my bill. "Thanks but no thanks" to those sites. Of the remaining sites, I found 2 or 3 too confusing and too difficult to navigate; so "no thanks" to them as well. This left me with four commercial switching sites and the comparator site provided by my very own Essential Service Commission (Victoria).[2]

As you may well imagine, I was soon overwhelmed by a plethora of electricity plans, discounts, special offers, bill estimates and claimed savings — with none of the sites seeming to agree on which retailer and which offer was best, or even cheapest, for my household.

The inconsistent and labyrinthine way in which information is provided within, and across, these sites means that anyone seeking to extract genuine, meaningful and verifiable information from these sources is subjected to what must surely be a modern day 'trial by ordeal'.

There is enormous inconsistency in the way these sites report tariffs and bill estimates; even within an individual switching site. Quoted benefits may or may not include some or all of the available discounts. They may or may not reflect sign-up rebates and other inducements. They may or may not include the GST. The sites may or may not explain how they have calculated potential bills or savings. And worse still, they contain errors; errors that, typically, only extensive cross-checking will reveal.

But I was determined. Even though I limited myself to the top 5 or 6 offers from the five sites remaining in my sample, I still spent about 10-12 hours trawling these websites for information, capturing that information in my spreadsheet and then confirming for myself that I could replicate the claimed benefits touted by each of the websites. In most cases, I *eventually* managed to replicate the claimed benefits (though I admit, at times it involved some cheating to do so).[3]

None of this left me brimming with confidence that my efforts had been particularly fruitful. I therefore turned to retailers' websites.

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[2] http://www.yourchoice.vic.gov.au

[3] Namely, I turned to the relevant retailer's website (or the Commission's comparator website: YourChoice), to help clarify the confusing information provided on the switching sites.

My purpose today is not to provide a detailed critique of those sites, *but*…
I will note, for the record, that they are of highly varied quality — for all the reasons I have already mentioned in regards to the switching sites, and for a range of other reasons. I will just mention a few weaknesses that particularly concern me: as a self-experimenting customer and as a regulator.

Veracity. While a lot of attention is paid to highlighting potential discounts — "Join now and save X per cent" — the basis from which the discount applies is rarely specified. It has been explained to me that this is a well-established principle of marketing, namely, that people respond to headline proportionate discounts much more readily than nominal savings or price offers. I will return to this issue in a moment.

Disclosure. Having seen these headline enticements, I then went in search of the product and price disclosure statements for the offers available to me. It is concerning (and indeed, a breach of licensees' regulatory obligations) that they are not always provided. It is almost as concerning that even when they are provided, it usually takes considerable effort (and I mean, *considerable*) to find them. There is rarely a simple, linear or logical path from a retailer's web-page headlining its offer to the product disclosure statement for that plan.

And, almost as concerning again, is how, even when provided, disclosure statements can be provided in a particularly unhelpful form. For example, one retailer provides all its disclosure statements, one for every plan on offer for every meter type for every distribution zone, in a single 90-page PDF document. This is hardly in keeping with the spirit of product disclosure.

Clarity. Just as with the switching sites, it is not always clear, whether the tariffs being quoted include some or all of the available discounts, rebates or other inducements. Again, in numerous instances, it required considerable effort to verify whether the tariffs being quoted were inclusive or exclusive of some or all of the potential discounts on offer.

In other words, answering the seemingly simple question: *What would I be paying if I signed-up with you?* took me at least another 5-or-6-or-more hours of self-experimentation.

Having exhausted all the readily available information and having amassed huge spreadsheets of data, I knew there was one final step upon which my experiment needed to embark. It was time to start phoning the retailers: to hear directly from them about the benefits they had to offer *me* — me as the regular customer rather than me the customer who was the regulator.

By now, however, I was twenty-plus hours into my self-experimentation and feeling like I had been thoroughly eviscerated. But unlike Evan O'Neill Kane, the American surgeon who had taken a scalpel to his own gut, I had lost the will to stitch-up the experiment.

And I had not even started investigating gas plans or dual fuel options.

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Let me now rewind to the start of my little tale of tribulation because I have not yet explained my reasons for having embarked on this endeavour of self-experimentation.

Two weeks after my appointment as Chair of the Essential Services Commission, Victoria removed the final vestiges of price regulation. After a series of reviews over a number of years, it was found that competition was now sufficiently mature to ensure that the market could deliver value for money to *all* customers without heavy-handed regulatory intervention in the form of price controls.

Looking back, and reading through those documents, what I suggest they found was, not that the competitive market was sufficiently mature, but rather, that the *conditions* for sufficiently mature competition were now in place. On this basis, Victoria fully removed it price controls and it did so on the expectation that competition could now take over from the regulator in driving efficient outcomes — not that it had yet taken over.

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Before I continue, let me state for the avoidance of *any* doubt, that I believe this was the right decision; and it continues to be the right decision. Nothing I say in the next few minutes should be construed as an advocation for re-regulating retail prices in Victoria.

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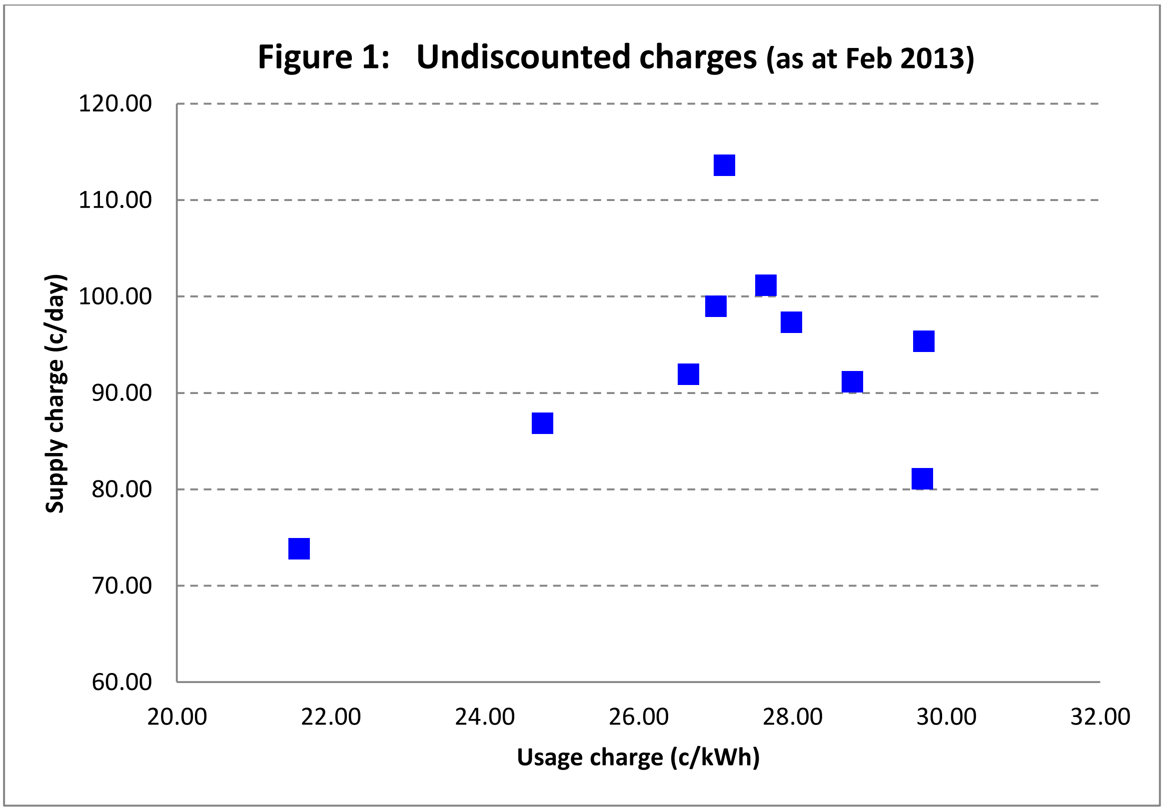
Now if my interpretation of those earlier reviews is correct — that is, that their findings were to limited to the *necessary conditions* required for mature competition — then surely we are obliged, with the benefit of hindsight and with a number of years of experience with deregulated markets, to ask: Were those necessary conditions the *sufficient* conditions for genuine competition? Alternatively stated: Once unencumbered by price regulation, has the competitive market indeed matured and delivered the expected benefits?

Within the scope of the broader energy market reform agenda, the test of those question relates to the realisation of greater economic efficiency. For today, I will just assert that the pursuit of 'greater economic efficiency' can be summarised under four headline objectives: (1) operational efficiency in all parts of the industry; (2) investment driven by the balance of supply and demand, rather than engineering whim; (3) the alignment of services with customer preferences; and (4) delivering those services at competitive prices.

My self-experimentation focussed on discovering whether the last of these four objectives has been realised.

The initial impression, after 20 hours of gathering and compiling the data, could be one of a market in which there is active competition. Small customers have access to around a dozen retailers. Most have at least one offer available to most customers. Some have multiple offerings. Plans vary by tariff structure, potential discounts and other inducements.   Figure 1 shows the spread of undiscounted market offers that were available to my household.[4,5]

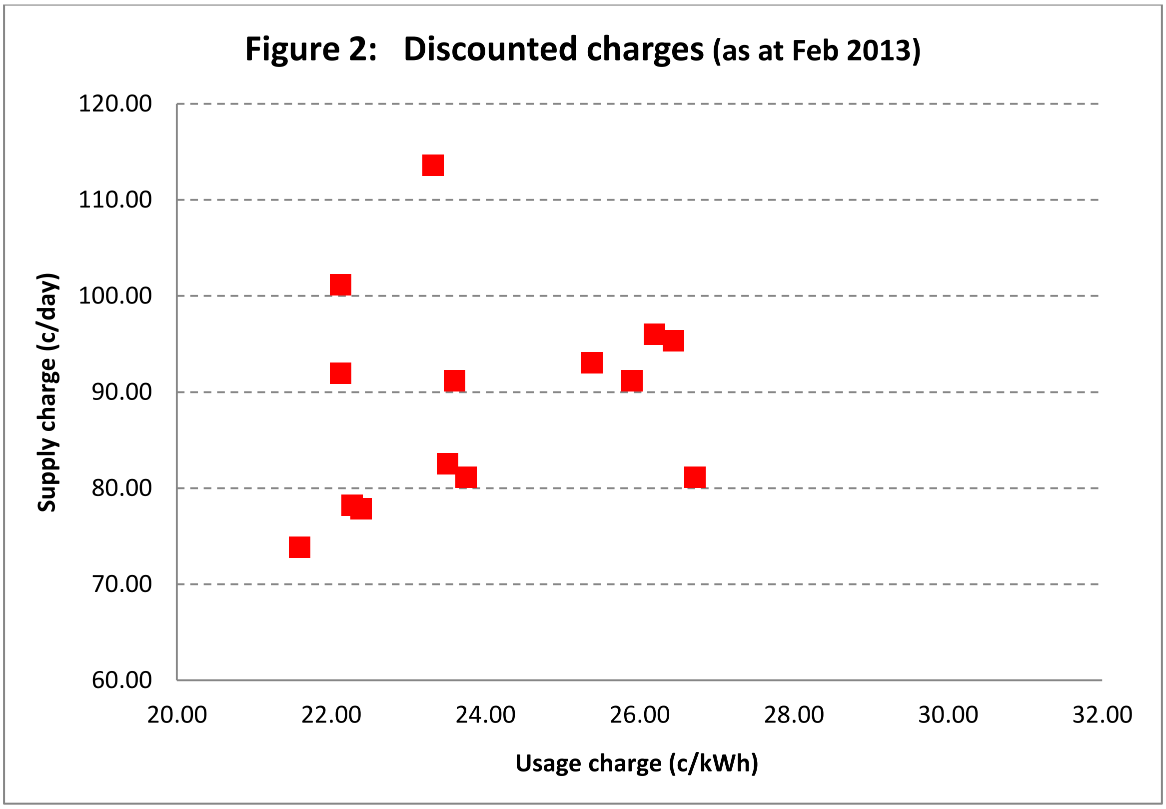


With the exception of the offer marked by the point in the bottom left hand corner of the diagram (which appears to be an outlier), Figure 1 suggets a certain degree of 'bunching' of offers.

Figure 2 shows that, when all available discounts are taken into account, the range of available offers shifts to the left (as you would expect) and the

[4] For the purposes of this analysis, electricity plans that offer to 'freeze' tariffs for a fixed period are excluded; likewise, plans that offer non-monetary inducements (such as rewards points) are not included.
[5] In some instances, retailers' undiscounted offers coincide. Therefore, two undiscoutned offers may appear as a single point in Figure 1.

dispersion of offers may have increased somewhat.[6] In other words, different discounting strategies by the retailers appear to produce somewhat more choice for customers.



Does this apparent variety of offers provide a sign of active and meaningful competition? Is it a sign of genuine customer choice?

Although it is not shown in Figure 2, the line-of-best-fit through these discounted market offers is only very weakly upward sloping. In other words, there is very little actual trade-off for customers between a high service charge and a low usage charge, and vice versa. The implication of this finding is rather interesting. It implies that despite the market appearing to offer numerous combinations of service charge versus usage charges, seemingly providing choice for customers, the only parameter that really matters in the usage charge.

[6] This analysis does not include benefits offered by virtue of nominal rebates (eg. '$X sign-up now' rebates).

Now, if that is the case, then what exactly are the competing propositions between which customers are being asked to choose?   What exactly is being gained in return for accepting a higher variable charge?

The apparent absence of a competitive trade-off between retail offers got me wondering whether my finding was an artefact of my methodology. That is, might the absence of genuine choice be an artefact of my household profile?

A little bit of further analysis revealed that unless a household was about a quarter the size of my own (in terms of its energy use), there was no significant trade-off to be made between the service charge and the usage charge. In other words, there was only a real choice among offers for households if their energy use hovered around 3 to 5 kWh per day or below — in which case, the best deal did depend on their expected electricity consumption (although the nominal difference between offers was small).

The significance of this finding is worth pondering — but I will leave that to another day.[7]

Another interesting feature revealed by my self-experimentation related to the conditional discounts on offer, or more precisely: the notional ‘penalty’ for not meeting all the requisite conditions. Figure 3 shows the dollar benefit my household would place ‘at risk’ if I failed to meet all the preconditions for the discounts. The horizontal axis ranks the offers from best to worst in terms of the annual cost for electricity that my household would incur.

Just eyeballing the data suggests there is a downward sloping relationship. If the seeming outlier in the bottom left corner is removed, the variance diminishes quite markedly.[8] A downward sloping relationship is hardly surprising. It effectively represents a risk sharing arrangement between retailer and customer.

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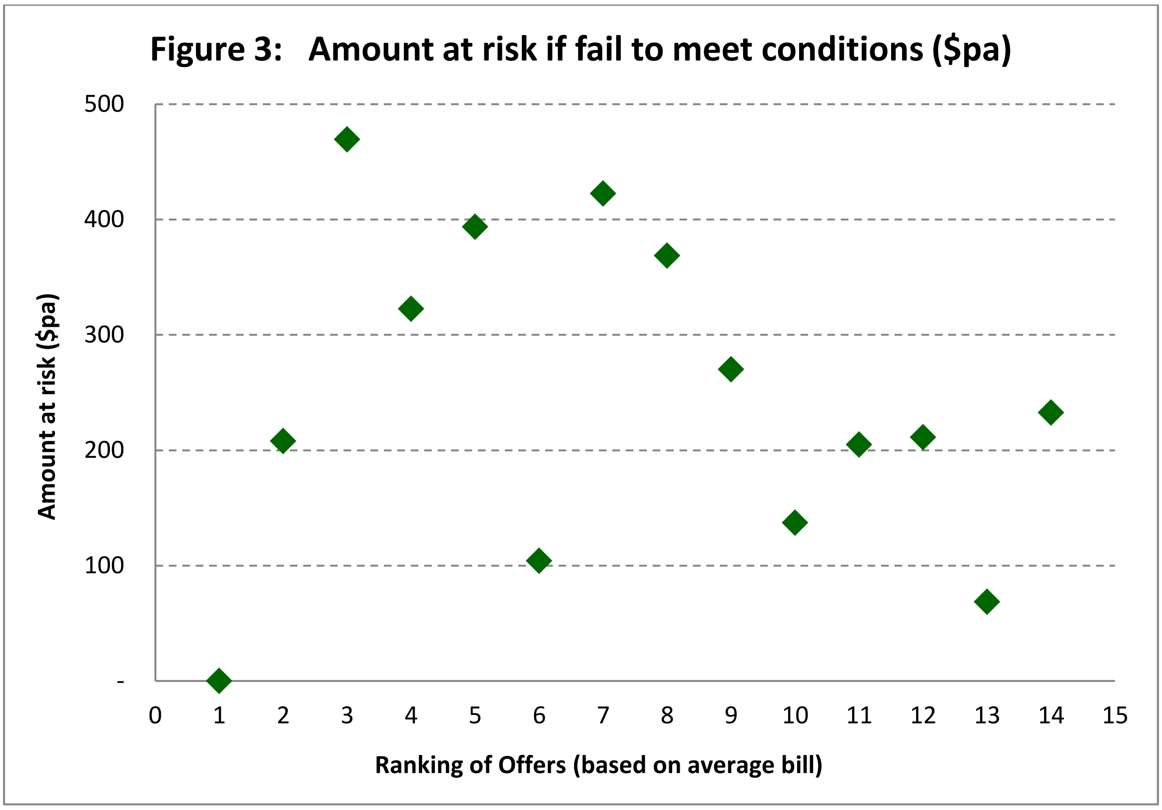
[7] Are retailers competing to attract, or not, low usage energy users?
[8] The R-squared measure improves by a factor of 10 times.

From a regulatory point of view, we need to ask: Is this sharing arrangement fair and reasonable?



We might well be inclined to argue that these are market offers into which two consenting parties have entered voluntarily; in which case they ought to be free to determine the extent to which they 'share risks'. But there are two issues that need to be considered before this interpretation can be confirmed.

First, do customers fully appreciate the significance of the conditional discounts on offer? Recall, my observation that a number of retailers make offers claiming 'Join now and save X per cent' without anchoring the basis from which the discount applies. In over half of cases, after trawling through the product disclosure statements, it seems to be the case that the discounts are applied to those retailers' standing offers (that is, standing contracts serve to anchor the discounts on offer). I do not recall whether this relationship was ever stated explicitly. Nonetheless, there were instances where there was no link back to the relevant retailer's standing offer. This lack of anchoring has two implications of note. First, the discounted offer can only be defined in relative terms (it is simply the offer available after discounting the undiscounted offer). Second, a customer can be worse-off on a market offer than on a standing offer if they fail to meet the conditions attached to the discount. (I have even heard, from people I trust on these matters, of customers on *discounted* market offers incurring higher bills than had they defaulted to the relevant retailer's standing offer.)

I suggest that a clear and transparent link between a market offer and a retailer's standing offer is essential for the proper working of the energy retail market. This linkage is important for a number of reasons.

Market offers come and go. They are made available for some months and then they disappear completely from public view. Of course, those customers who signed-up for those offers continue to be billed in accordance with those plans. But as we know, retailers can alter tariffs during the course of a contract (unless they specify otherwise). So once a market offer is 'closed' and no further information is made publicly available by the retailer, affected customers have no means to verify whether they are still receiving the promised discounts. They have no means to verify whether the retailer is continuing to honour the risk-sharing 'bargain'.

Standing offers, at least in Victoria, must be gazetted and cannot be revised more than once every six months. Consequently, standing offers provide a reliable anchor for customers wanting to verify whether they are continuing to receive the promised discounts once retailers have closed those market offers.

Alternatively, I suppose, we could consider requiring retailers to provide a public, readily accessible and up-to-date register of every tariff within every market plan to which they have customers signed.

Of course, if we were to go down the more expedient path of just linking market offers to the standing offer, then it would be necessary for retailers to make information about their standing offer readily accessible. This is not the practice at the moment. (Even where product disclosure statements can be found for standing offers, the documentation is rarely explicit that these are the standing offers to which customers will default — for example, at the end of their current market contracts.)

The second matter that needs to be taken into consideration when asking whether it is fair and reasonable for market offers to provide a 'risk sharing' component is highlighted by the following example.

During my research, I found that if I met all the required conditions under one of the contracts on offer, my annual bill would be in the order of $1,880; but if I failed to meet the conditions, my bill would be $2,350 per year. That is a big spread that provides a big incentive to meet the conditions. That's all fine; but what about that retailer's standing offer? If for whatever reason, I was on that retailer's default contract my annual bill would be around $2,030.

In other words, by meeting the retailer's conditions I could save about $150 per year on the standing offer, but would pay an excess of $300-plus over the standing offer if I failed to meet the requisite conditions. That's a two-to-one ratio of up-side to down-side. And though I may have entered this contract completely voluntarily, at what point does 'risk sharing' start to look like a penalty payment? This question is of particular relevance in Victoria where late payment penalties are prohibited by legislation.

In the months ahead, we will be turning our minds to these issues, namely:

- How should discounts be presented to ensure maximum transparency about the potential benefits and costs to customers?

- What is the most effective and efficient way of supporting customers on closed market offers who may want to verify that they are still receiving promised benefits?

- When do ‘risk sharing’ arrangements start to resemble late payment fees?

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All of this leads to a separate, but related, discussion about retailers’ marketing practices. I do not want to say too much about this matter today; and I note the ACCC has been active in this area. Nonetheless, somewhat conveniently, during my period of self-experimentation, we were door knocked by one of the retailers. I was not home, but my wife kept a record of what transpired.

While the sales agent was polite, personable and seemingly knowledgeable about her company and its products — so no complaints on that front — there were at least two highly concerning aspects of this interaction.

First, when asked for written material about the contract on offer, the agent replied that this could not be provided. When my wife specifically requested an ‘Offer Summary’ (that is the official term in Victoria), the agent advised that she could only provide this information if we signed-up with the retailer. Even when my wife advised the agent that there was a regulatory obligation to provide an Offer Summary, it was not forthcoming.

All of this occurred despite me, now as the industry regulator, having multiple assurances from this retailer — and indeed, all retailers operating in Victoria — that they comply with their regulatory obligation to provide an Offer Summary when requested.

And just in case you might be tempted to suggest that this must have been the actions of a rogue sales agent — which invariably is retailers’ excuse when asked to explain — then let me tell you that exactly the same thing happened to another one of my Commissioners just four days later. That involved a different retailer door knocking in a completely different area of Melbourne.

The second action of concern by the sales agent who door-knocked our house relates to the tariffs that were quoted. When my wife showed me the promised tariffs (remember, she had written them down because no documentation was provided), they looked suspiciously low. A few minutes of research revealed that the agent was quoting GST-*exclusive* prices for that contract without any declaration whatsoever to this effect.

Had we signed-up on the spot, and depending on the information that may or may not have been subsequently provided to us, we may have only become aware some months later that we had been misled; that is, when we received our first bill from the new retailer.

And all of that despite the fact that there are federal laws about such matters.

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Now I am just one customer and maybe this was all a random event, but it is hard to believe this is the case. Certainly, the anecdotal evidence suggests otherwise.

I find it contemptible that despite codes and guidelines that have been in place for many years, and despite numerous compliance audits and letters of assurance from retailers, and despite laws about the GST that have been in place for over a decade, and despite the Australian Consumer Law coming into effect, and despite the ACCC taking retailers to court and fining them for inappropriate representations, and despite the industry's actions to establish Energy Assured Limited to prevent such behaviours . . . that despite all these developments, we continue to observe such flagrant disrespect for the law and contempt towards consumers.

Of itself, such behaviour does not lend credence to the long-cherished goal held by some advocates that door-to-door marketing by energy retailers ought to be prohibited. Nonetheless, the time has come to have a broad-ranging discussion about the role of door-to-door marketing and how we, in the regulatory community, can better deal with behaviours that are illegal, immoral or both. We need more reliable means for ensuring it operates honestly and respectfully; and breaches are met with enforceable and punitive sanctions.

To the extent that these means cannot be identified, or they can be identified but not enforced readily, then the question may need to be asked: What limitations might we place on this form of marketing? Examples could include: prohibiting sales at the first point of contact or requiring sales agents to make prior appointments before door knocking a customer.

I am sure there are many creative ways of constraining door-to-door marketing; but we need to be certain of the problem before we jump to its solution.

These issues are probably too broad for any single regulator to address; be they an industry regulator or a consumer protection authority. Perhaps it is time for a 'coalition of the willing' across interests and jurisdictions to initiate a proper discussion about the realities of door-to-door marketing and if need be, the appropriate remedies.

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My frustration with these issues about marketing emanate from an earlier concern; one that I first raised in July 2011.[9,10] At that time I sought to highlight the seemingly questionable fairness of so-called 'fixed term' contracts. Despite being fixed term, they were not *fixed price* contracts. At least in Victoria, retailers have been able to change tariffs, largely at will, with only the merest of

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[9] Ben-David, Ron (2011) *Next steps for the regulator of Australia's most deregulated retail energy market.* Industry briefing to the Energy Retailers Association of Australia (21 July 2011)

[10] Further discussed in: Ben-David, Ron (2012) *Retail energy markets: A case for economics redux.* Consumer Utility Advocacy Centre (7 March 2012)

requirements of forewarning to customers. Retailers would counter legitimately that this arrangement is offset by the regulated low early termination fees; allowing dissatisfied customers to switch to another retailer at low cost.[11]

At first blush, that sounds like a reasonable trade-off. Looking a bit more deeply, however, questions arise.

Exit fees vary enormously. Individual retailers seem to have applied various interpretations to the regulatory limitation that they can only charge a maximum early termination fee of $20 plus a proportionate return of any inducements paid to attract the customer. It is that latter provision that has been interpreted variously and sometimes very liberally. Most interestingly, it seems numerous retailers interpret their discounts to be 'inducements' which they then seek to clawback through their exit fees if a customer terminates the contract.

Now, if such discounts are offered subject to customers meeting certain conditions, and indeed, if there are penalty-like consequences for failing to meet those conditions (see earlier discussion) — then those conditional discounts cannot be treated as an inducement. In which case, they should not be subject to clawback if a customer terminates a contract. As far as the retailer ought to be concerned, the cost of a conditional discount should be offset by the probabilistic event that the customer will not meet the conditions requisite. This suggests that retailers may be 'double dipping' at customers' expense if they seek to clawback the cost of a conditional discount when a customer terminates such a contract.

Moreover, if a customer (or a regulator) has no means by which to verify the basis against which a discount is applied (recall my earlier comments), then how can a customer assess whether the proposed exit fee is proportionate to the inducement? Indeed, are discounts even to be considered as inducements? And

[11] The Victorian regulations allow retailers to charge a maximum early termination fee of $20 plus a proportionate return of any inducements paid to attract the customer.

all the more so if they represent 'risk sharing' arrangements such as those mentioned a few moments ago?

We intend examining this issue more closely in the months ahead.

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Beyond these concerns lie other barriers for customers wishing to exercise some form of countervailing power in the market place.

As my self-experimentation has highlighted, it takes hours to gather enough information to make a confident decision about switching to another retailer. And of course, when alternative retailers are also offering fixed term but not fixed price contracts, then any apparent benefit to be gained from switching retailers can evaporate even before a customer receives their first bill from a new retailer.

A few years ago, the industry defence in the face of increasing energy costs centred on pointing at increases in the wholesale price due the drought. Those pressures have now receded. More recently rising network costs have been the focus of industry blame for price rises — as well as various policy interventions such as the federal carbon pricing mechanisms and other, so-called, 'green schemes'.

But how is a customer to know — and how is the regulator to know — whether observed price increases are due to the pass-through of increasing non-retail input costs; <u>or</u> whether they are due to retailers' inefficient operational practices due to a lack of genuine competitive pressure; <u>or</u> whether they represent an extraction of economic rents arising from emerging market power by the retailer energy industry.

I am currently pursuing some analysis, on the second and third of these possible explanations by looking at the relationship between input costs and retail prices over the last few years. For now, I have no results to report about retailer margins so I will confine my comments to a discussion of the issue of cost pass through.

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Network costs are subject to full-blown economic regulation. Last year saw much 'hoo-hah' about the effectiveness of that regulatory regime. As a result, modifications have been made — greater powers and more resourcing for the regulator have been announced; greater public debate about trade-offs (especially regarding reliability standards) and other matters-that-matter; and greater customer representation in the determination process.   It is hard to be too critical about these developments.

However, if, as I would like to suggest, the weakest aspect of the regulatory regime is that its result in an 'arms race' between the regulat<u>or</u> and the regulat<u>ed</u>, then we ought to ask whether any of these developments will remove or mitigate the causes of that gamesmanship and brinkmanship?

The building block – CAPM – RAV – WACC – CPI-X model[12] has served us well for twenty years but have we reached the point of diminishing (or even negative) marginal returns?

But debating regulatory methodology is not where I think the real challenge ends; or even begins.

Perhaps we ought to be rethinking the value of network infrastructure — not just its value in terms of dollars but the benefit and social welfare it produces for customers, the community, the economy and future generations. Rethinking the *value* of network infrastructure is the greatest challenge, and the greater opportunity for reform, that lies ahead.

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[12] Capital Asset Pricing Model (CAPM), Regulatory Asset Value (RAV), Weighted Average Cost of Capital (WACC).

To be clear, this is not just a question about regulatory methodologies such as the 'building block' approach just mentioned. It goes to the heart of the entire legal construct surrounding the energy market. This stretches beyond the National Energy Law and its Rules and Codes and Guidelines. Competition laws and consumer laws and other laws (such as privacy laws) may also be preventing certain futures from ever emerging — even though those futures may produce greater value for customers, the community, the economy and future generations.

Let me pose this challenge differently by asking: What possible futures might be precluded because of the current regime that presides over our network infrastructure and indeed, the entire energy market? Might the network and supply solutions for Richmond, Richmond, Richmond, Richmond and Richmond look far more different than their present similarities suggest?[13]

I make no pretence of being a technologist. I have no idea what weird or wonderful futures may be possible but, say, could one of those Richmonds become self-sufficient and disconnect *en mass* from the network — or does the entire governing machinery make such a future highly improbable or even impossible?

Fortune-telling should never be the role of someone in a position like mine. Nonetheless, I am sure that every person in this room could imagine a future, not matter how wild or woolly from today's perspective, that probably could not emerge due to regulatory barriers. These barriers to seemingly fanciful alternative futures may exist by virtue of intentional prohibition or inadvertent preclusion. The barriers may arise by virtue of the advantages or incentives the rules impart for incumbents; or the barriers might result from a prohibitive wall of red tape confronting a new-comer or a first-mover.

[13] That is, Richmond (NSW), Richmond (Vic), Richmond (Qld), Richmond (SA) and Richmond (Tas).

If we can imagine even a single scenario that could not eventuate within the current framework, no matter how seemingly implausible by today's standards, then how many other futures might also be precluded? And if that is the case, then how confident can we really be about our ability to adapt and evolve as new challenges arise; to adopt and exploit the new opportunities that will emerge?

*

I have strayed somewhat from my initial line of inquiry about customers' ability to ascertain whether observed price increases on their energy bills are due to exogenous cost pressures, particularly increasing network costs.

It may be true that customers do not really care too much about what happens 'on the other side of the meter'. In other words, customers do not differentiate, or want to differentiate, or need to differentiate, between retailers and distributors and transmission owners and generators. I suspect we can safely assume that for most customers, it is just one amorphous and nebulous electricity industry. Indeed, in Victoria, it is amazing how many people with whom I speak still believe the State Electricity Commission remains involved in the provision of the State's power — and that is after almost 20 years of privatised provision and disaggregated ownership.

If customers are not fussed about the difference between a retailer, a distributor and others in the supply chain, then should we in the regulatory community be similarly indifferent? I suggest the answer is 'no'. We should *not* be indifferent. We should not be indifferent to the drivers of price increases. We should not be indifferent to exposing those cost pressures to the greatest public scrutiny possible.

Every so often, the issue of 'unbundling' energy bills raises its head — that is, disaggregating a customer's bill (as it is presented to the customer) to highlight the different elements that go into that bill. Doing so, could certainly include separately itemising regulated network charges.

The contra-argument is typically along the lines of increased compliance costs for retailers (which, of course, ultimately would be passed on to customers in higher prices) with little claimed benefit for customers; particularly if most customers focus only on the ‘amount owing’.

I have some sympathy for these view, however, I have *no* sympathy for their consequences.

Those consequences include the ability for retailers to perplex, to avoid and to shirk. To perplex customers by never clearly having to articulate the value added they provide to those customers. To avoid accountability by always being able to point the finger at others as the cause of price increases. To shirk responsibility by showing little (or no) interest in actively pursuing lower costs on behalf of their customers. Indeed, why is it that we do not see retailers engaging in exercises such as the AER’s regulatory price determinations even though it affects the prices they charge their customers? (See Box 1)

Box 1: Potential explanation for retailers' observed non-engagement in network price determinations

The following reasons might be proffered to explain retailers' seeming indifference towards regulatory price determinations for network operators. The reader is left to judge which explanations, if any, are the most likely or most probable.

- *Regulatory rebound* - whereby retailers operating in jurisdictions which retain retail price regulation, will not engage in any discussion of regulatory parameters affecting network operators that might subsequently affect their own price determinations.
- *B2B retaliation* - whereby retailers, who are unavoidably dependent on distribution businesses, fear 'upsetting' the distributors who might then use their leverage to disrupt a retailer's business operations (for example, by withholding customer consumption data).
- *Family secrets* – whereby retailers and distributors know more about each other's business operations than is known by the regulator. Retailers avoid 'spilling the beans' on distributors, in order to avoid the distributors responding in kind.
- *Free riders* – whereby no individual retailer will incur the cost of engaging with a distribution price review because the benefits of success will be shared equally with other retailers even though they have not contributed to the cost of that engagement.
- *Tribal loyalty* – whereby retailers and distributors, despite being different businesses (often with different owners), retain a greater loyalty to each other than to customers or the regulator.
- *Indifference* – whereby retailers had become accustomed to a largely inelastic demand curve that allowed them to pass higher costs directly on to their customers without fear of lost sales.

How, in these circumstances, can customers be expected to hold energy retailers to account (whether individually or as an industry)? Hold them to account for the services they provide; the *value* they create for their customers; the value-for-money proposition they have to offer.

Competitive markets are heavily dependent on these notions of, what I like to call, **'competitive accountability'** — namely: customers' ability to observe the services being delivered, to identify the *value* being added by their retailer and to assess the value-for-money being offered by the retailer.

I am not sure enough attention is given to this notion of 'competitive accountability' within the broader regulatory community involving regulators, policy departments and bodies of review. Too often and too readily, the assumed answer (or more accurately: the *asserted* answer) to observed weaknesses in market competitiveness is to produce, or require to be produced, more information for customers.

More information seems self-evidently a worthwhile outcome. However, we ought to be mindful that, at best, the benefits produced by increased information probably suffer from diminishing marginal returns. At worst, those marginal returns may even turn negative (resulting in a Laffer Curve relationship between the amount of information produced and the effectiveness of that information). After all, we live in a world of information *and disinformation* overload.

So more information, for example, through an unbundling of customer charges, may not support the pursuit of greater competitive accountability. Perhaps we need to think harder about other mechanisms that promote competitive accountability; some of which may be structural.

Perhaps the time is coming where we need to consider structurally separating customers' bills whereby networks would be responsible for billing for regulated network charges; and retailers would bill separately for those services that are largely provided through competitive markets.

Admittedly, customers are unlikely to be enamoured with another set of utility accounts. There would be some initial confusion, and possibly resentment, when two sets of accounts arrive in the mail: one account from the customer's retailer and another account from the distributor. But let us try to think beyond that initial reaction and look to the longer term benefits.

Whether they like it or not, customers are already engaged in a three-way relationship with their retailer and their distributor. Most only realise this complexity when they lose their power for any length of time. In other words, most customers have no realised relationship with their distributor. What a fabulous proposition for a business: provide a service with largely guaranteed anonymity. Where is the accountability in such an arrangement?

It is true that the AER (and previously, each State's regulator) steps into the breach by monitoring performance and compliance, and reporting publicly. While this is indisputably an important mechanism that must continue, we also have to accept that probably one per cent of one per cent of one per cent of the population have any knowledge of, or interest in, these regulatory activities and reports. Correspondingly, the AER (and others) would acknowledge that it is effectively impossible to engage customers in consultative mechanisms involving network regulation.

I suggest this disinterest and disengagement would change if customers were given a separate and direct line of sight to their network service providers and their charges.

And what would this structural separation of billing do for the relationship between retailers and customers?

It would establish a level of 'competitive accountability' that barely exists today. Rather than focussing on why others are responsible for price increases, retailers would need to focus on the value they have to offer. Rather than sending our notices every six-to-twelve months advising of price increases due to circumstances created by others (which, by the way, invokes the distinct impression that these price increases cannot be avoided by going to another retailer), retailers would need to focus on one of two strategies. Either they would need to avoid cost increases through more efficient operational, financial and risk management strategies; or retailers would need to focus on creating better value for their customers in return for those higher prices. What is not to be desired in such an outcome?

And, it is possible.

The Lines Company in New Zealand separately bills its customers for the network services it provides (see Box 2). Amongst other benefits, it notes on its website that such an arrangement enables its customers to *"closely compare the* *prices and conditions offered by different energy retailers and choose the one that best suits* [them].*"*

I do not delude myself about the contentiousness of any attempt to structurally separate billing for network and retail services. But nor do I delude myself about the impact and benefits that this step would produce for customers; benefits that regulatory compliance and reporting mechanisms cannot achieve.

Box 2: The Lines Company Ltd

The Lines Company is a distribution company in New Zealand. On its website, it describes itself as "the Company that looks after the power line network in the North Island's 'King Country' region of New Zealand." According to its website, the Lines Company has around 20,000 customers, including domestic consumers and holiday home owners through to major industries like NZ Steel and McDonald's Lime.

In its Terms and Conditions document, the Lines Company states:

The Lines Company provides the network that enables electricity from local generators and the national grid to reach your installations. This electricity is sold to you by your retailer. Your retailer only charges you for the cost of the electricity itself; our charges cover the cost of our network and the amount we pay Transpower for the national grid.

As our charges cover infrastructure that cannot be taken away, they must be paid while your private line and the installations connected to it remain connected to our network, whether or not that connection is energised. This ensures that installations with identical network requirements end up paying the same amount.

We will bill you directly. This enables us to have charges that more closely match our cost of supply and therefore minimise subsidies among customers. It also enables you to closely compare the prices and conditions offered by different energy retailers and choose the one that best suits you.

Source: *Domestic & Commercial Connection Terms and Conditions 2009.*[14]

[14] http://www.thelinescompany.co.nz/termsandconditions/Terms_Conditions_2009.pdf

Conclusion

It seems that I have drifted a long way from where I began. I started by recounting my dalliance with self-experimentation in search of a better electricity deal and ended-up talking about a separation of billing.

The thread that links these stories, and the ones in between, is competition; or more precisely, the pursuit of the most competitive outcomes that can be sustained in our energy markets.

Genuine competition is far more effective than regulators in meeting consumer interests; at matching the vagaries of consumer preferences with open-ended opportunities for innovation in service delivery. New production, storage and appliance technologies are hurtling their way down the innovation curve; and new metering technology is about to take us to the cusp of a very different future for the first time in almost a century. We ought to be modest enough to acknowledge that many of the possible futures 'out there' may bear only a passing resemblance to the past with which we are so comfortably familiar.

Whether those possible futures are realisable, or whether they are denied, will depend entirely on the access, incentives and enabling conditions faced by all of the relevant interests: customers and suppliers; present and future. Competition can deliver those benefits but it will only do so if that competition is genuine and it favours no interest above another. Genuine competition in energy retail markets is tough. It is tough because it is <u>not</u> about lower prices or more energy plans. It is <u>not</u> about higher customer churn rates or greater market share. Genuine competition is tough because it is about an <u>unending</u> pursuit — a pursuit that involves: defining, creating and delivering 'value'; 'value' as perceived by customers — not regulators or industry or advocates or policy makers.

But, if the opportunities for competition are limited, possibly due to inherent limits in our market, then the regulatory endeavour must turn to maximising competitive accountability.

And if that be so, then the challenge before the regulatory community will not be found in economic platitudes; in mantras about lower prices or more retailers or more offers or higher churn rates or cutting red tape.

Genuine competitive accountability demands a 'balance of power' between all relevant interests. Most importantly, there must be a balance of power between consumers and suppliers — suppliers as we know them and suppliers we cannot yet imagine; customers of today and customers of tomorrow.

Regulators must ensure, to the maximum extent possible, that customers can hold energy retailers to account — to hold them to account for the services they provide; the *value* they create; and the value-for-money they have to offer.

— END —

Regulating retail energy markets in the long term interests of consumers

Dr Ron Ben-David*
Chairperson
Essential Services Commission

The Essential Services Commission is Victoria's economic regulator. The Commission regulates the Victorian retail energy sector through monitoring and enforcing compliance with licence conditions and Victoria's energy retail codes. In this Paper, Dr Ben-David reflects on the regulatory objective of 'promoting the long term interests of consumers'. He argues that while this objective is consistent with economic efficiency, the long term interests of consumers may not be achieved through the converse regulatory objective stated in terms of economic efficiency. Dr Ben-David argues the role of the regulator in Victoria since full deregulation of energy prices in 2009, must be to promote a market place that is free of favour or bias towards any particular party or any particular outcome.

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* The opinions expressed in this presentation are those of the author alone. They do not represent the views of the Essential Services Commission, its staff or the Victorian Government. The author takes full responsibility for any errors, omissions or conjectures made herein.

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I love words. Indeed, I am fascinated by them.

Sometimes, words can be perfect. Sometimes a phrase can so perfectly capture a moment, a mood, a thought, an aspiration, a truth.

> ***In the beginning**, God created the heavens and the earth.*
>
> Genesis 1:1

So powerful are these words that they redefined the course of human civilisation. They redefined our place in the universe and indeed, the universe itself. That opening phrase, “In the beginning” is perfect. It is absolute in its meaning and its implication requires no qualification. No reader in few thousand years has been left in question about what preceded those words, what preceded that ‘beginning’. Nothing. It was *the* Beginning; the beginning of everything we know, everything we can imagine and everything beyond our imaginings. The power of that opening phrase lies in its unconditional displacement of the human urge, and universe’s quest, for symmetry.[1]

> ***We hold these truths to be self-evident, that all men are created equal**, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness*.
>
> United States Declaration of Independence

Has a more remarkable phrase ever been crafted in the English language? The absolute authority and compelling certainty that these words project into the world are astounding in their perfection. They contain and convey a complete absence of self-doubt; self-doubt in the minds of the authors — those giants of American history: Thomas Jefferson, John Adams and James Madison. Even two centuries later, the reader is granted no room to doubt.

[1] For example, Newton’s third law of motion: *To every action there is always an equal and opposite reaction.*

And a little closer to home…

> ***Well may we say "God save the Queen" because nothing will save the Governor-General**.*[2]
>
> Gough Whitlam, 11 November 1975

Even those members of today's audience who are too few in years to recall this colossal moment in Australian history, can be left without any doubt — for the words contain completely the rage of their speaker. There is no need to resort to Youtube or to turn to the many historical accounts now available in bookstores and libraries. The words are completely self-contained. By pivoting quintessentially about the abstract noun, 'nothing', this statement embodies a moment forever. It embodies a thought forever. It embodies a mood forever.

(And just as a footnote to that moment: When reflecting on his words many years later, Whitlam immodestly observes[3], "The Secretary read the proclamation and, of course, I made the most memorable speech ever made in that building.")

*

So we have three sets of words, from three very different times, formulated in three very different circumstances: one set of words perfectly expressing the notion of existence; another set of words perfectly expressing the value of life; and another set of words perfectly expressing a sense of rage.

*

[2] At 4.45 pm on 11 November 1975, standing on the steps of Parliament House with Whitlam towering over his shoulder, the Governor-General's private secretary, David Smith, read the proclamation dismissing the Whitlam Government. Smith concludes with the words: "God save the Queen." Whitlam then responds.
[3] See (at 3:02): http://www.youtube.com/watch?v=QgEHBjq5p2E

Those of us operating in the regulatory world — whether you be a regulator, a policy- or rule-maker, an industry participant whether publicly or privately owned, a customer or an ombudsman — we all operate in a world of words. And outside the tax and superannuation worlds, is any world more verbose and prolix than the world of energy regulation?

There must be thousands and tens of thousands of pages of legislation, regulations and Orders; rules, codes and guidelines; draft and final decisions and determinations; issues papers and discussion papers, inquiries and reviews; audits and performance reports; conference proceedings and Powerpoint presentations.

Even within this vast sea of words, sometimes, just sometimes, there are words that ring more resonantly than the rest; words that rise above the mire of clauses and provisions, sections and sub-sections, within which they can be found.

The Essential Services Commission Act, the words that govern my existence, imposes upon me an objective. This objective articulates my reason for existing as the economic regulator in Victoria.

> ***…the objective of the Commission is to promote the long term interests of Victorian consumers.***
>
> Essential Services Commission Act 2001 (Vic) s.8

When it comes to legislative drafting, counsel is rarely known for its poetic flair. But, those words, "to promote the long term interests of Victorian consumers", resonate above the din of the statutory chatter that emanates from the other 75 pages of my Act.

I can take no credit for those words: "to promote the long term interests of Victorian consumers". I wish I could, but I cannot. They precede my time at the Commission. But I doff my hat to this statement. It embodies a moment, a mood, a thought, an aspiration, intended to guide the Commission's daily awareness of the responsibility entrusted to it.

Of course, and rightly, the scope and reach of those words is not left to the whim of the Commission. The Act also specifies a range of matters to which we must have regard "in seeking to achieve the objective".[4]

These words, or something akin, are not unique to the Victorian economic regulator. In South Australia, the corresponding Act states that the regulator…

> ***…must have as its primary objective protection of the long term interests of South Australian consumers***
>
> Essential Services Commission Act 2002 (SA) s.6(a)

The words look similar, but there are some differences. In South Australia my colleagues are required to 'protect' certain interests, whereas I am required to 'promote' them. I am not sure this is just a matter of semantics. There is, however, another difference that I think is more interesting. The South Australian Act refers to the Commission's 'primary objective' and in doing so, implies the existence of other objectives. Though not expressed in such terms, these subsequent implied objectives come in the next section, which states that the South Australian Commission must "at the same time, have regard to the need to" achieve a set of outcomes specified in the legislation.[5] The weight attached, or to be attached, to these subsequent implied objectives remains unspecified. All we know is that the subsequent implied objectives carry less weight, jointly and severally, to the primary objective.

Interestingly, the subsequent implied objectives of the South Australian regulator are very similar to the matters to which the Victorian regulator must have regard when seeking to achieve its *only* objective.

[4] Section 8A(1)
[5] Section 6(b)

Once again, I am not sure the differences in the words are just a matter of semantics.

In contrast to Victoria and South Australia, the regulators of New South Wales and Queensland are not given an objective. Their governing Acts specify the purpose of their existence by virtue of the functions they must perform and how those functions are to be performed and what matters must be regarded when performing those functions. In the two northern States, actions define existence; whereas in the two southern States, existence defines actions.

This is quite an intriguing philosophical difference, but I will not explore it any further for now.

*

Of course, all these regulators continue to play a role in the energy markets of their respective States. Those roles differ by State and presumably they are of interest to those attending this conference.

Within, around and beyond these State based regimes, rests the national energy framework established collectively by the States and Commonwealth governments. And there, deep in the bowels of that prodigious compendium of rules and regulations, in section 7 of Schedule 1 of Part 8, rests the National Electricity Objective which is:

> ***to promote*** *efficient investment in, and efficient operation and use of, electricity services for* ***the long term interests of consumers of electricity***
>
> National Electricity (South Australia) Act 1996

There are some interesting similarities and differences between the National Energy Objective (NEO) and the State-based objectives just discussed. The relevant verb of this objective is ‘to promote’. The relevant objects of this statement are consumers, however, in the NEO they are limited to being consumers of electricity only. This is not all that surprising given that this is the objective of a law regarding the regulation of electricity rather than the objective of the bodies performing that regulation. Nonetheless, later provisions tie the relevant actions of the MCE, the AER, the AEMC and AEMO to that objective.[6] So while it would be incorrect to state that the National Electricity Objective is also the objective of these different entities, it clearly bears heavily on their considerations. This contrasts with, say, the Victorian regulator's objective which does not limit the type of consumer according to the service being consumed.[7]

But there may be an even more interesting consequence of limiting, at least indirectly, these entities to only promoting the interests of 'consumers of electricity' rather than pursuing the interests of consumers more generally.

To explore this difference, I need to slip into economic-speak for a moment.

The entities guided by the National Electricity Objective must, by law, assume that consumers have a very simple utility function, *U(x)*, whereby consumer utility is solely dependent on the consumption of a single good: electricity.

$$\boldsymbol{Maximise\ U}(\boldsymbol{x}) = \sum_{\boldsymbol{t}=\mathbf{1}}^{\boldsymbol{T}} \sum_{\boldsymbol{i}=\mathbf{1}}^{\boldsymbol{I}} \boldsymbol{U}\,(\boldsymbol{e_{it}}) \quad \textit{with respect to } \boldsymbol{e_{it}}$$

where $\boldsymbol{e_{it}}$ represents the electricity consumed by customer i at time t

In other words, by supporting the consumption of energy, the regulator seeks to maximise consumer interests, or consumers' utility, across all consumers and across the relevant time frame.

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[6] These acronyms stand for: the Ministerial Council for Energy (MCE) now known as the Standing Council for Energy, Australian Energy Regulator (AER), Australian Energy Market Commission (AEMC) and Australian Energy Market Operator (AEMO).

[7] Section 8(2) states: *Without derogating from [its objective], in performing its functions and exercising its powers in relation to essential services, the Commission must in seeking to achieve the objective … have regard to the price, quality and reliability of essential services*. While this links the objective to the Commission's powers in relation to essential services, it does not do so in a way that limits the objectives to only applying to considerations affecting consumers of those services.

The Victorian objective does not restrict the regulator in the same way. Rather, it allows the regulator to recognise that consumer utility derives from factors other than energy.

$$\boldsymbol{Maximise\ U}(\boldsymbol{x}) = \sum_{\boldsymbol{t=1}}^{\boldsymbol{T}} \sum_{\boldsymbol{i=1}}^{\boldsymbol{I}} \boldsymbol{U}\,(\boldsymbol{X_{it}}) \quad with\ respect\ to\ \boldsymbol{e_{it}}$$

where $\mathbf{X}_{it} = [a_{it}, b_{it}, c_{it}, d_{it}, e_{it}, f_{it} \ldots]$ represents a vector of goods and services consumed by customer i at time t, including the consumption of energy (e_{it})

This is not to suggest for a single moment that, if the Victorian regulator was still regulating electricity prices, we would be taking into account consumers' consumption of, say, choc tops and crop tops. Of course not. It does mean, however, that *relative* preferences matter — that is, consumer utility also depends on the weights attached by consumers to the consumption of the different goods and services in the vector X_{it}.

This approach recognises the desire for electricity is complicated by competing desires to also consume movie tickets and cappuccinos and iPads. We should also not lose sight of the fact that for many members of the community, the desire to consume electricity is complicated by more fundamental needs such as: paying the rent and feeding the family and buying petrol just to get to work; consuming electricity today and saving a little bit for tomorrow.

Confining a regulator or rule-maker to viewing consumer interest as being solely dependent on the consumption of energy, isolated and abstracted from the rest of consumers' reality, underestimates the complexity of the decisions facing those consumers; it understates *their* interests and their *long term* interests.

The difference between these two objective functions has, I contend, consequences for the attainment of economically efficient outcomes. And, of course, economic efficiency is the 'mission statement' of economic regulation.

As any university student with ten minutes of microeconomics can tell you, there are three headline types of efficiency: productive, allocative and dynamic.

Productive (or technical) efficiency refers to how well an existing firm is utilising its inputs in order to deliver a given quantum of output. Over the longer term, it refers to how well firms can alter their mix of inputs in order to deliver a given or greater quantum of output.

Allocative (or inter-sectoral) efficiency refers to how well resources are deployed across the broader economy in order to deliver the quantum and mix of goods and services desired by consumers. That is, given existing technologies, it describes how well firms satisfy consumers' preferences for different good and services.

Dynamic (or inter-temporal) efficiency refers to how well firms adapt to changing circumstances: most particularly, advancing technology and evolving consumer preferences. History suggests that future technological advance is likely to be no less capricious in the future or that consumer preferences will shift any less whimsically than in the past.

I contend that a regulatory objective articulated in terms of the 'long term interests of consumers *of electricity*' leaves the outlook of rule-makers and regulators focussed narrowly on pursuing productive efficiency in regulated firms. It does so by virtue of excluding allocative efficiency by definition and in doing so it also limits the regulator's purview of shifts in indirect consumer preferences. This leaves the regulator to pursue operational efficiencies in the regulated entities. This requires the regulator to either: overcome the schism of information asymmetry by amassing enough knowledge about the inner works of the regulated firms; or it must develop the skills to create incentives for the regulated entities to reveal their true costs of operating efficiently.

Whether either of these requirements can be, or has been, satisfied is a discussion for another conference.

Nonetheless, while a focus on productive efficiency may produce outcomes that also deliver allocative and dynamic efficiency, there is no *a priori* reason to assume that this must or will be case. Alternatively stated, productive efficiency is a necessary but not sufficient condition for allocative efficiency. Is this limited view of efficiency the regulator's concern? No. The regulator is doing the job placed before it in pursuing productive efficiency. Might this be a concern for society? Well, yes, if as a result of this imposed limit on the regulatory framework, opportunities afforded by, say, new technologies are not being pursued by the regulated entities.

This might help explain the flurry of activity by policy- and rule-makers last year, as they and the community increasingly came to the realisation that the regulatory framework may have been driving too little in the way of true innovation; and maybe even less in the way of responsiveness to customer interests.

To be completely clear, this suggestion is not intended as a criticism of any of the national bodies I mentioned a moment ago; rather, it is an observation about the context in which they operate and the consequences of having them operate in that context. Likewise, my comments are not intended to suggest that everything would have been so much rosier had they been operating subject to a different objective.

It *is* my intention today to highlight questions about why we have economic regulation (and for today's purposes, economic regulation of the energy sector) — and to highlight the role of consumer interests or economic efficiency or both or neither, in guiding the exercise of that economic regulation.

*

My friend Paul Kerin at the South Australian regulator has argued we should do away with regulatory objectives centred on the long term interest of consumers.[8] Paul eloquently argues that such objectives introduce too many degrees of freedom, too much discretion and too much ambiguity, into the task before the regulator. In some instances, he argues, this may “force regulators to make decisions that are inconsistent with economic efficiency” — particularly if, or when, they feel obliged to address issues of equity or when they pursue decisions that seek to *protect* customers without those customers bearing the direct costs of that protection. Paul contends that ideally the regulatory objective should be couched solely in terms of economic efficiency. The Productivity Commission has argued along similar lines (at least with reference to the regulation (or not) of the urban water industry).[9]

I am troubled by suggestions that the regulatory objective could or should be expressed solely in terms of economic efficiency. Efficiency *per se* is not a human trait. It is a characteristic of the firm; or more precisely, processes within and across firms. Productive efficiency is a characteristic that applies to a process within a firm. Allocative efficiency is a characteristic that applies across firms’ production processes. And, dynamic efficiency is a characteristic that applies to firms’ production processes across time.

‘Efficiency’ is a characteristic of a process.

I do not want to be the regulator whose interest is a ‘process’. I do not want to be the regulator who is so removed from humanity that consumers are nothing more than ‘representative agents’ who sit at the end of a process. I do not want to be the regulator that dehumanises people or is dehumanised in the way I am required to think about the purpose of my role; indeed, my objective as a regulator.

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[8] Kerin, Paul (2012) *In whose interest?* Network. Issue 43. March

[9] Productivity Commission (2011) *Australia’s Urban Water Sector. Final Inquiry Report*. Report no.55. August. Canberra

The firm only exists by virtue of its ability to meet the needs and desires of consumers; people. The successful firm meets those needs successfully. The failing firm has either not understood those needs or desires, or has been unable to meet those needs and desires at a price that aligns with consumers' marginal utility from consuming those goods or services.

The firm is the vehicle. Consumer utility is the destination. Reaching the destination requires the vehicle but the vehicle has no purpose without the destination. It is a perfect symbiosis.

But if it is so perfect, then: Whither the regulator?

The answer, of course, is that the symbiosis may not always be perfect. Sometimes, one party is captive to the will and the whims of the other. The symbiosis then becomes, or at least has the potential to become, exploitative.

The shortcomings of monopolies and oligopolies are well established, as is the need for regulatory oversight of these markets; all the more so when they involve the provision of essential services.

Regulation may be the second best option; but there may be no first best option — at least not within current realities.

The regulator must therefore exist, but it occupies the most precarious of places: resting between otherwise symbiotic parties. In these circumstances, how can the regulator operate to the effective benefit of both parties rather than to their joint or several detriment?

The answer is straight forward.

Effective regulation requires that no firm is favoured over any customer; and that no customer is favoured over any firm. No customer cohort is favoured over another (whether spatially, demographically, socio-economically or temporally); and no firm is favoured over another (whether spatially, temporally, technologically or commercially). Balance must be pursued or maintained at all times. Anything else would require the regulator to know more about the symbiotic relationship than the parties themselves. That would be a most arrogant position to uphold given that, at least to the best of my knowledge, neither side of that relationship will have had a say in the appointment of the regulator — and rightly so.

Effective economic regulation therefore seeks to promote the proverbial 'level playing field' between firms; between customers; and between firms *and* customers. Economic regulation in pursuit of the long-term interests of consumers, when conducted according to these principles of non-favouritism, represents the pursuit of an economically efficient outcome.

I am not sure I can trust the reverse to be true. I cannot have the same level of confidence that placing the production process at the centre of the regulatory system, economic efficiency rather than long-term interests of consumers, will produce outcomes that are indeed aligned with those long-term interests. If the production process takes precedence, particularly if efficiency is confined (or largely limited) by intention or by inevitable circumstances[10], to pursuing productive efficiency only, then regulatory outcomes may neither be efficient nor meet the long term interests of consumers.

The regulatory exercise must be about pursuing those long term interests; meeting the needs of people rather than trawling over the entrails of processes.

And before I am misquoted about my reference to "meeting the needs of people", let me absolutely clear: this is not about predicting the needs of the people. It is not about determining who amongst the people takes precedence. It is not about guiding or instructing firms about how to meet the needs of the people or what those needs might be; or what those needs ought to be. As I said just a moments ago, "That would be a most arrogant position."

[10] For example, by informational asymmetries.

As an economic regulator, my interest is in ensuring firms' production processes and customers' preferences (neither of which I can ever know enough about) … my interest is in ensuring that these two parts of the economic equation are brought together without favour and without bias.

To be clear, and self-evidently, the principle of acting 'without favour and without bias' applies in the exercise of regulatory authority. But that is not what I actually meant when referring to bringing the two parts of the economic equation together without favour and without bias. Rather, my statement is intended to refer to economic regulation pursuing *outcomes* that are without favour or bias. These are the outcomes that would be achieved if consumers and producers negotiated outcomes under circumstances that did not favour one party over another; and through mechanisms that were free of biases towards any particular party or any particular outcome.

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This is where, I would like to suggest, economic regulation departs from other forms of regulation.

I am sure that many regulators would claim to be acting in the interests of consumers in one way or another, even though those words are unlikely to appear in their governing statutes. And, I am sure, that they would be genuinely motivated by this objective. In many cases, I would expect that words of similar effect have probably been crafted into those organisations' corporate objectives. After all, pursuing the interests of consumers or citizens or just plain old 'people' is the reason many of us get involved in developing, administering or delivering public policy.

But I contend that the difference between so-called 'economic regulators' and other regulators is that other regulators are established precisely to act with favour and bias. Do not get me wrong, that is not a criticism. Acting to prevent illness through, say, food poisoning or exposure to hazardous chemicals, are worthy and economically justifiable interventions. (*How* these interventions are performed in a way that is *most* economically justifiable is a discussion for another day.) But these interventions are intended precisely with the objective of favouring one party over another. That is legitimate and worthy and fair. But it differs markedly from the *raison d'etre* and *modus operandi* of economic regulation.

The lack of appreciation of this difference has been one of my on-going sources of intellectual frustration when dealing with bodies responsible for regulatory reviews.[11] And I have argued, though to no great avail, that economic regulators have far more in common with these bodies of regulatory review than they have in common with other regulators.[12]

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So, what does all this mean for the economic regulation of the energy sector? What are the implications for the community and the sector of having an economic regulator acting to promote the long term interests of consumers?

The answer differs somewhat, but not a great deal, depending on whether the regulator is pursuing this objective in the context of making a price determination or in the exercise of its non-pricing functions.

At the beginning of 2009, the last vestiges of price regulation were removed in Victoria following a review by the AEMC a year-or-so earlier.[13] This review followed two earlier reviews by my predecessors at the Essential Services

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[11] Ben-David, Ron (2011) *Submission to the Productivity Commission's inquiry into Australia's Urban Water Sector*, June

[12] Ben-David, Ron (2012) *Neither service provider nor customer be.* University of South Australia Competition and Consumer Conference, October

[13] AEMC (2007) *Review of effectiveness of competition in electricity and gas retail markets in Victoria: First Final Report*

Commission. Victoria's progress towards price deregulation is described in a background paper to be published on our website.[14]

Despite no longer being the price regulator of any part of the Victorian energy supply chain, I would still like to reflect on the significance of an objective of promoting the long term interests of consumers for price regulation. (Note, we remain the price regulator of the Victorian water industry and so these observations are directly relevant in that context.)

I am a little concerned that much of what was decided late last year through COAG and elsewhere, was about involving consumers in the *regulator's* processes. The AER's move to establish a Customer Reference Panel and the proposed establishment of a Consumer Challenge Panel are two endeavours of interest.

In the main, these proposals relate to the relationship between consumers and the regulator. I have no objection to strengthening that relationship. As I have said to consumer representative bodies in my jurisdiction, as a regulator, I need to feel the 'hot breath' of consumers ruffling the back of my neck at all times. Regulatory accountability is primary. No arguments from me.

The problem, however, with the aforementioned institutional arrangements is that it upholds a notion that regulated entities need not, or are not particularly expected to develop relationships with customers — that the regulator stands between service providers and customers; that the regulator shields service providers from having to directly or overly engage with customers; that the regulator somehow is expected to play a representative role on behalf of customers when engaging with the regulated service providers.

This runs counter to my earlier arguments. It places the regulator in the invidious position of having to *represent* customer interests in its dealings with

[14] Essential Services Commission (2013) *Progress of electricity retail competition in Victoria: Background Paper*, May.

regulated service providers; and conversely, having to explain (even defend) those service providers' expenditure proposals as though the regulator were responsible for those proposals. The regulator becomes the 'go between' taking responsibility for everyone's interests; frustrations; ambit claims; etc.

In the context of price regulation, fulfilling the regulatory objective of 'promoting the long term interests of consumers' must be about finding a way to involve consumers directly in the planning processes of the regulated entities. This must involve finding a way, or different ways, to reveal customer preferences to service providers. And then, there must be a way for the regulator (and consumers) to confirm that those preferences have been taken into account in the investment and operational plans of the price-regulated entities. Were this not the case, there would be no means for confirming the regulatory guarantee that approved expenditures were in line with customers' long term interests. It simply would be left to the regulator to form an *impression* of those interests and then to assess whether the regulated entities' proposed plans conformed to those impressions.

The Productivity Commission's draft report last year into *Electricity Network Regulatory Frameworks* recognised this risk, at least in part.[15,16] The Commission recommended the establishment of:

> *"a single but broadly representative consumer body with expertise in economic regulation and relevant knowledge and understanding of energy markets [to] represent the interests of all consumers during energy market policy formation, regulatory and rule-making processes, merit reviews, and negotiations with providers of electricity networks and gas pipelines."*

Unfortunately, the Productivity Commission left somewhat ambiguous the scope of the last reference to "negotiations with providers of electricity networks and gas pipelines". In the body of the report, the Productivity

[15] Productivity Commission (2012) *Electricity Network Regulatory Frameworks*, Draft Report, Canberra.
[16] The Productivity Commission submitted its final report to the Commonwealth Government on 9 April 2013. Under the *Productivity Commission Act 1998*, the Government is required to table the report in each House of the Parliament within 25 sitting days of receipt.

Commission clearly supports a direct relationship between consumers and the regulated (network) providers, though this is only in the context of a future framework comprising negotiated settlements (which it does not specifically recommend).[17]

I suggest that a direct and required relationship between consumers and regulated (network) providers should not be limited to a framework comprising negotiated settlements. It should be central to any and every regulatory framework involving these providers.

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Turning to non-price regulation…

This is the regulatory 'space' in which my Commission now operates in energy; and it is difficult. A couple of years ago, I first began reflecting on what it means to be the 'regulator of Australia's most deregulated retail energy market'.[18] Moreover, I am now expected to perform this role in a policy environment that emphasises reducing the regulatory burden; or 'cutting red tape'. Despite this, I am still obliged to promote the long term interests of Victorian consumers in relation to essential services, including the electricity and gas industries. I do not take this obligation lightly.

In part, at least, I have been placed in this position because of the AEMC's review of market competitiveness in Victoria. Therefore, that report might be a good place to start any reflections on being the 'regulator of Australia's most deregulated retail energy market'.

Recently, I have argued that the AEMC review (and the preceding reviews) found, not that the competitive market was sufficiently mature, but rather, that

[17] See p.714

[18] Ben-David, Ron (2011) *Next steps for the regulator of Australia's most deregulated retail energy market*. Industry briefing to the Energy Retailers Association of Australia (21 July 2011)

the *conditions* for mature competition were in place.[19,20] On this basis, Victoria fully removed it price controls and it did so on the expectation that competition *could* now take over from the regulator in driving efficient outcomes. In other words, the AEMC's findings were limited to matters pertaining to the *necessary* conditions required for mature competition. It did not, and probably could not, draw conclusions about whether all necessary *and sufficient* conditions for genuine competition were satisfied.

A few years on, then, and with the benefit of the experiences afforded by those few years, it would seem that the economic regulator's role is to test whether genuine competition has indeed emerged in Victoria; and to do so in order to better understand its remaining role in pursuing the long term interest of consumers.

Over the last two-or-so years, I have become increasingly perplexed about the path of electricity prices in Victoria — at least as faced by residential and other 'small' customers. It is not just the price path *per se* that is of interest. We need to be asking: What might prices be telling us about the state of competition in our local electricity market?

After many discussions with informed and trusted peers, I know that I am not alone in being confounded by the trends shown in Figure 1.

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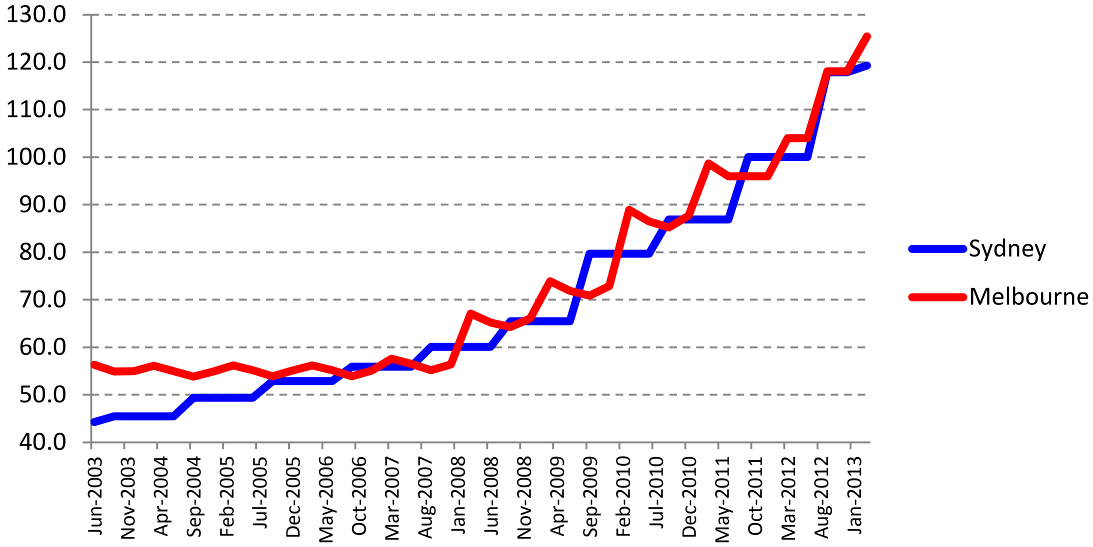
[19] Ben-David, Ron (2013) *Pursuing competitive accountability in retail energy markets*. Energy 2013 Conference, March

[20] The AEMC review applied six broad tests to assess whether the Victorian energy retail markets had reached a stage where they were effectively (or workably) competitive. These were: (i) independent rivalry within the market, (ii) ability of suppliers to enter the market, (iii) exercise of market choice by customers, (iv) differentiated products and services, (v) price and profit margins, and (vi) customer switching behaviour.

Figure 1: Electricity Price Index: Sydney and Melbourne



Source: ABS *Consumer Price Index, Australia,* Cat no. 6401.0

Both cities encountered a structural break in the trend line in around 2008-2009 when prices started to increase more rapidly. What is most confounding for the Victorian regulator of Australia's most deregulated electricity market is not that we encountered a structural acceleration in prices. Rather, the confounding aspect of the lines shown in Figure 1 is that our prices have been increasing at the same rate as in other jurisdictions since 2008-2009. This is despite: (1) a general softening of wholesale prices across the latter period; (2) the absence of the same network cost drivers as in other places;[21] and (3) the claim to hosting Australia's (and even the world's) most competitive retail market.[22]

It should be noted that Victorians also encountered the costs of the smart meter roll-out by the distribution businesses during this period. This should have largely been reflected as a one-off step increase in prices in 2010. It does not, however, explain the underlying trend increase.

[21] See: Victorian Electricity Distribution Businesses (2012) *Submission to the Senate Select Committee Inquiry on Electricity Prices*. September.

[22] Energy Retailers Association of Australia (2012) *Global report shows Australian energy markets are leading the world*, Media Release, June.

A revealing hint into this confounding state of affairs was afforded by an AEMC's report in late 2011 into possible future price movements.[23] That report showed that the retail component of Victorian electricity prices was four-and-a-half times bigger in Victoria than in NSW and three-and-a-half times bigger than in Queensland.

I know those findings are loaded with caveats. I fully acknowledge the AEMC's cautionary declarations — but I would also suggest that it requires an awful lot of caveats to explain such huge discrepancies between retail margins in Victoria and elsewhere.

A more recent report from the AEMC, released in March this year, is a little harder to interpret and it is more caveated than the earlier report.[24] One observation, though, is worth making. Comparing the possible future prices identified in the earlier report with actual and estimated prices identified in the latter report, it seems the AEMC's earlier look to the future was most wrong in Victoria. This can be seen in Table 1. Whereas the AEMC's earlier report over-estimated future possible prices in NSW and Queensland by about one-and-half cents per kWH on average, it *under*-estimated average prices by about three-and-half cents per kWH in Victoria.

[23] AEMC (2011) *Possible future retail electricity price movements: 1 July 2011 to 30 June 2014. Final Report*. November
[24] AEMC (2013) *Electricity price trends, Final Report: 1 July 2012 to 30 June 2015.* March

Table 1: AEMC's possible future residential electricity price movements (c/kWh)

		AEMC 2011 Report	AEMC 2013 Report	Difference between Reports
NSW	2010-11	22.8		
	2011-12	26.2	25.4	-0.8
	2012-13	31.6	30.4	-1.2
	2013-14	32.2	30.0	-2.2
	2014-15		31.0	
Qld	2010-11	20.7		
	2011-12	22.1	22.1	0.0
	2012-13	27.1	25.6	-1.5
	2013-14	29.3	27.1	-2.2
	2014-15		27.9	
Victoria	2010-11	22.9		
	2011-12	24.5	28.8	4.3
	2012-13	28.7	31.9	3.2
	2013-14	30.3	32.9	2.6
	2014-15		35.2	

To be clear, this is not a criticism of the AEMC or its methodologies. Not at all. My concern lies elsewhere.

These results are generated by the AEMC having exactly the same level of insight into the wholesale, network and policy costs faced in all jurisdictions — that is, network costs are equally transparent in all States and presumably the AEMC is no better (on average) at estimating future wholesale costs in one State over another. In other words, I would not expect any systematic bias towards any one-or-more States in the AEMC's approach.

The unknown and seemingly highly unpredictable component in electricity pricing would, therefore, appear to be retail margins — most evidently in Victoria.

So, what is going on in Victoria? Why does it seem that there are higher, and potentially widening, retail margins in Victoria? How is it that the apparently high levels of competition in Victoria are sustaining accelerating prices not supported by the underlying cost drivers?

I have heard numerous explanations (which I won't attribute) including: these findings (and others) are based on standing offers rather than competitive market offers; competition is expensive for the retailers who incur costs in attracting and retaining customers; and, retailers are extracting excess profits in Victoria to compensate for the lack of opportunities in other States.

(On the first of these proposed explanations, it should be noted that standing offers in Victoria are also not regulated. They are determined by retailers operating in the market place.)

Let me proffer another couple of explanations of my own for why prices might be higher in Victoria than would otherwise be expected based on the fundamentals: Either, competition is not operating effectively in terms of driving retailers' costs towards their long-run margins; or, *as an industry*, retailers are extracting economic rents from the market.

I suggest that these are two potential symptoms of the same causal factor — namely, insufficient competition in the market place.

"What?" you might be gasping. "But Victoria has the most competitive market in the country!"

Maybe so. Maybe so. But…

Is it *sufficiently* competitive? Is it *sufficiently* competitive to push retail operating costs towards their long-run margins *and* prices towards those long-run marginal costs? After all, that is the definition of a competitive market — not customer churn rates, or the number of offers in the market place, or the number of retailers vying for custom, or low barriers to entry.

And if not, if the market is indeed insufficiently competitive, then *why* not?

There are numerous possible answers.

Perhaps it has something to do with the size and configuration of our market in Victoria and in Australia: multiple sources of energy and many millions of users dispersed over long distances but clumped quite densely. Or maybe the retail industry, though not necessarily individual firms within that industry, retains some measure of market power — possibly by virtue of electricity being an essential service under no threat from substitutes. Or maybe, it has something to do with the regulatory environment within which these retailers operate. Does that regulatory environment somehow, in some way, fail those tests I urged before: namely, producing outcomes that are tainted neither by favour nor bias towards any particular outcome or any particular party?

And if any one or more of these possibilities does indeed uphold a finding that the market is not sufficiently competitive, then what?

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For Victorians and the Victorian regulatory community, the answer to that last question is of immediate import. In the months ahead, the roll-out of smart meters will be largely completed and a moratorium on flexible tariffs will be lifted. It will be time for the community to start seeing a return on its very large investment in this new technology.

I am in *no* doubt that the return on this investment will only be maximised if competitive tension within and beyond the electricity retail industry is also maximised. The reasons are both intuitive and complex.

On the intuitive side, I do not think it is an exaggeration to state that smart metering technology has the capacity to alter the value proposition delivered by the electricity industry like nothing we have seen since the industry came into existence almost a century ago. But technology in-and-of itself has no value. Of course, the value comes from how different parties look to exploit that technology. In other words: innovation and the unending drive to out-innovate others. And nothing drives innovation like the competitive quest. If Victorians are to receive a robust 'rate of return' on their investment in smart meters, then we need robust competition seeking ways to exploit that opportunity.

The more complicated aspect of that story requires that I, again, slip into econo-speak; this time using the language of welfare economics. In that long-established branch of economics, the total benefit that accrues from a market is shared between producers and consumers in the form of producer surplus and consumer surplus, respectively. For today, I can merely assert that the informational advantage that smart metering technology affords suppliers (with its high frequency reading and reporting about customer usage patterns), has the potential to support price discriminatory pricing to an extent that has previously been impossible.

From an efficiency point of view — and here it is worth recalling my earlier concerns about limiting the regulatory objective simply to the pursuit of 'efficiency' — from an efficiency point of view, price discrimination can be an optimal outcome. It can ensure the quantity of a good or service produced and consumed is optimal. In short, price discrimination ensures customers pay their true and individual valuations for the energy they consume; and therefore, producers will produce exactly that amount for which customers are willing to pay; at the price they are willing to pay. Like I say, nothing wrong with that as far as efficiency is concerned … except maybe this: in the limit, it means that producers expropriate all consumer surplus.

Is that bad? Not in itself, after all consumers only end-up paying what they are willing to pay. But is it fair? Is it equitable? We economists tend to shy away from questions about equity, preferring those issues to be dealt with by others.

There may, however, be other reasons, reasons other than equity, to question whether the potential expropriation of this consumer surplus through price discrimination is economically disconcerting.

First, let me note, that I am not suggesting that the expropriation of consumer surplus will emerge immediately on the uptake of flexible prices; far from it. It will take some time, maybe years, for retailers to gather the necessary information and develop the required algorithms. Moreover, this is also not an 'all or nothing' proposition. The capacity for retailers to price discriminate will vary over time, and place, and customer type. But, it *will* become increasingly possible.[25]

This is disconcerting, even from an efficiency perspective, because the information benefits afforded by smart meters will be asymmetric — lopsided because while retailers (and others) will gather more information about customers, customers will not be gathering any more information about retailers (or indeed, any more information about supply chain costs: the costs of producing and delivering electricity or the cost of managing the attendant risks of doing so).

This informational asymmetry provides retailers (and others) with a competitive advantage over customers; tipping the market in favour of one party over another. This cannot be good for economic efficiency — particularly allocative and dynamic efficiency. Therefore, we need to find a way that ensures retailers are forced into revealing their true marginal costs at the same time as customers are being forced into revealing their usage preferences. And what is the most effective way so far invented for achieving that outcome? It is certainly not price regulation.

[25] Of course, at the same time customers have access to more information about themselves by virtue of the information smart meters will be collecting. This is a bit of an odd concept for economists.

The most effective way so far invented for driving price towards the long run marginal cost of production is … competition; genuine, hard-edged, sink-or-swim competition.

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Herein lies my reason for being so concerned about the level of competition in the market place. If competitive tension in the energy retail market is insufficient, if it is not driving costs towards their long run margins and if it is not driving the pursuit of better and more valuable customer offerings, then we cannot be assured that the full benefit of smart meters will be realised in the interests of customers; in the long term interests of consumers. And if that is the case, then I cannot be sure that, as the relevant regulator, I am discharging to the best of my capabilities my obligation to promote the long term interests of consumers — to promote economically efficient outcomes.

Whether in the old world or the new world of smart meters, it is the incumbent duty of the regulatory community to minimise lopsidedness; favour or bias. I repeat: effective regulation requires that no firm is favoured over any customer; and that no customer is favoured over any firm. No customer cohort can be favoured over another; and no firm can be favoured to the detriment of another.

Conclusion

In concluding this paper, I do not intend to summarise my discussion about whether regulatory objectives are better focussed on economic efficiency or on pursuing the long term interests of consumers. Nor will I repeat my arguments for pursuing to the greatest degree possible, regulatory processes and outcomes that are free of favour or bias.

Instead, I offer the following two statements.

First, let me state for the avoidance of *any* doubt, that nothing I have said throughout this presentation should be construed as an advocation for re-regulating retail prices in Victoria. Heavy-handed price regulation is not compatible with vigorous competition; and it is genuine competition that will produce the greatest benefits for consumers.

Second, is to advise you that in the days ahead, we will be releasing a report into retail electricity margins in Victoria over the last few years. We commenced this work late last year as an alternative test of market competitiveness. The underlying hypothesis, as mentioned a few moments ago, is that insufficient competition will lead to higher prices due either to: insufficient pressure to lower costs towards their margins, or due to the extraction of industry rents.

Without giving anything away, let me state that, as a regulatory community, we have more work to do. We have more work to do to ensure that the market is as absolutely competitive, as absolutely possible; that competitive tension in the retail energy market is as genuine as possible; that the regulation of that market is as free as possible from favour or bias; and, that the energy industry enjoys as little market power as possible in the provision of an essential service to consumers.

— END —