

Submission to the Essential Services Commission – Developing a reference price methodology for Victoria’s energy market

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By email: RetailEnergyReview@esc.vic.gov.au

Essential Services Commission

Level 37, 2 Lonsdale Street

Melbourne, Victoria 3000

Dear Secretariat,

The Consumer Policy Research Centre (CPRC) welcomes the invitation to comment on the ESC’s *Developing a reference price methodology for Victoria’s energy market* consultation paper.

CPRC is an independent research organisation which undertakes research to inform policy reform and business practice change. Our goal is to achieve a fair outcome for all consumers. We conduct research across range of consumer markets, with a focus in 2018 on consumer decision-making, housing, consumer data and the online marketplace. CPRC supports reforms to increase consumer comprehension, comparability and switching. As is the case with many reforms aimed at changing consumer experience and behaviour, monitoring of the information, tools and platforms consumers access to support informed decision-making and the outcomes of these changes should be ongoing. Developing a regulatory and policy environment which is iterative and informed by ongoing consumer research will ultimately assist in delivery of evidence-based interventions to improve outcomes from consumer engagement through time.

Developing a reference price methodology for Victoria’s energy market

The Commission has outlined the intended purpose of the reference price is to give effect to recommendation 8A from the final report of the *Independent Review of the Electricity and Gas Retail Markets in Victoria* – which recommends enhancing the commission’s market monitoring roles and responsibilities. However, the commission has also outlined in its consultation paper its intention to develop an ‘efficient price’.

In the development of any reference price based on representative retailer, we encourage the Commission to consider the intended purpose. This may be for analysis purposes, or price signalling purposes to industry or price signalling to consumers. The policy application should be a central design consideration.

Developing a reference price - or a single efficient price - as an analytical tool may serve a useful purpose in the Commissions' competition review. It is unclear if this means there would be one single price developed for the entire retail market in Victoria, or for example, a single price for each distribution zone.

A more nuanced range of costs accounting for the different costs faced by retailers of different sizes may be useful to understand efficiency and competitiveness in the market than developing a representative retailer based on an aggregate of different retailers' costs. Differently sized retailers will face significant variation in generation costs depending on their degree of generation ownership and ability to secure hedges. Operational costs may vary dramatically due to significant variation in the amount of outstanding debt that retailers carry, the cost of capital parameters and risk factors that may vary significantly between large and small retailers.

Moreover, the electricity and gas network businesses have different pass through costs. Aggregating different distribution charges would have implications for the costs borne or retained by retailers. Accounting for the different distribution zones separately may be a more appropriate approach to assessing the competitiveness of the market and identifying efficient prices for retailers in different network jurisdictions.

We note the Commission's admission that it has not received direction or advice about purpose of the proposed efficient price from the Victorian Government. While we recognise the Commission's intended purpose of the efficient price, there may be far reaching implications for the electricity retail market in Victoria if the proposed efficient price was adopted as the basis of the Basic Service Offer (BSO), which is currently under consideration. The methodology and design of an efficient price for the purpose of developing a BSO would need to consider a range of eligibility criteria questions and distributional impacts.

CPRC recommends that the Victorian Government and Essential Services Commission give further thought to the purpose of the reference price, and further develop the evidence-base in relation to the current and intended distributional impacts of reform either before or through the development of a Basic Service Offer. CPRC recommends that the Victorian Government closely consider what outcomes are intended to be achieved through a price intervention mechanism. The development of a Basic Service Offer could be defined in many different ways - some options are further explored in this section.

1. Examples of price intervention, regulation and monitoring tools used internationally

In response to concerns about essential service markets are not operating effectively for consumers, especially disengaged or vulnerable consumers, a range of interventions and tools have been adopted in different jurisdictions around the world. A summary of such interventions and outcomes can be found below.

- **Limiting the number and type of energy offers**

A concern often raised in relation to the operation of retail energy markets is the number and complexity of different products available in the marketplace. Ofgem's

2012 Retail Market Review led to limitations on the number and type of tariffs offers retail energy providers could offer. The reforms included:¹

- a maximum limit on the number of core tariffs (four) that could be offered by retailers at any point in time;
- simplifying tariff structures to ensure that all tariffs have a simple standing charge (which could be zero) and unit rate structure (no multi-tier tariffs);
- simplified how discounts were offered and presented;
- migrated consumers from closed offers to open offers where this provided a benefit; and,
- facilitating collective switching schemes.

However, evidence suggests that consumer engagement did not improve - consumer switching rates fell after the introduction of the reforms, and perceptions of complexity of the market did not change.² The CMA also found that around 70 percent of the customers of the 6 largest energy firms remained on the more expensive 'default' standard variable tariff.³ The CMA analysis suggested that in a fully competitive market – in which all British consumers had switched to a market offer – would have saved British consumers £1.7 billion a year.⁴ The CMA ultimately recommended Ofgem remove the RMR measures, finding that these had the 'effect of dampening price competition between suppliers', by either:

- 'directly restricting their ability to compete to acquire or retain customers through the tariffs or discounts they offer'; or
- 'adversely affecting the incentives suppliers have to compete by making it more costly to offer customers cheaper prices or discounts (the effect of which is to reduce the competitive pressure suppliers exert on their rivals)'.⁵

CMA also found that limiting retail tariff offerings to four tariffs was particularly problematic because it restricted the ability of suppliers to offer tariffs designed for specific groups rather than mass market tariffs - e.g. 'tariffs aimed at low consumption users, tariffs aimed at certain social groups and tariffs with particular characteristics such as 'green tariffs' and tracker tariffs'.⁶

- **Price cap**

Though the CMA suggested a range of measures to replace the RMR measures, in late February 2018, the Domestic Gas and Electricity Bill was introduced to the British Parliament. If passed, the legislation would impose a price cap as determined by the regulator on a 6 monthly basis – which will notionally reduce the cost of a standard variable tariff (comparable to Victoria's standing offer) through this price ceiling. The cap would be in place until 2020, at which point the regulator will be able to determine whether to keep it in place until 2023 or remove it.⁷ The cap is intended

¹ Ofgem, *The Retail Market Review – Implementation of simpler tariff choices and clearer information*, 27 August 2013, 11-12.

² KPMG, *Energy retail markets – An international review*, A report for the Victorian Department of Environment, Land, Water and Planning, April 2017.

³ Competition and Markets Authority (CMA), *Press release - CMA sets out energy market changes*, 10 March 2016 <https://www.gov.uk/government/news/cma-sets-out-energy-market-changes>

⁴ Ibid.

⁵ CMA, *Energy Market Investigation, Final Report*, 24 June 2016, 573-4.

⁶ Ibid.

⁷ Ben Chapman, 'Energy price cap triggers mixed reactions from consumer groups', *The Independent*, 26 February 2018. <https://www.independent.co.uk/news/business/news/energy-price-cap-triggers-mixed-reactions-consumer-groups-money-saving-expert-martin-lewis-a8229696.html>

to reduce the discrepancy between those consumers on a market offer and those on the standard variable tariff, who often have not switched in years.⁸ While this is estimated to reduce bills for disengaged consumers, active consumers will likely be able to find cheaper plans, though it is unclear what the effect of this will be on the market.⁹ Consumer organisations, such as Citizens Advice have welcomed the cap, noting the bill 'will go some way to ending the unacceptable overcharging of loyal customers, and will cut prices for 12million households currently stuck on poor value default tariffs'.¹⁰ Conversely, the Competition and Markets Authority had considered and expressly rejected the idea of a price cap, noting that a price cap potentially diminishes the incentive for consumers on higher priced offers to switch to lower priced offers, reducing competitive pressure on suppliers and 'likely resulting in worse outcomes for customers in the long run'.¹¹ Others note that the cap may not address the underlying issues in the British energy market – namely pricing complexity and consumer loyalty leading to higher prices rather than lower prices.¹²

- **Price re-regulation**

In another example of price regulation, electricity prices were re-regulated after a relatively short period of deregulation (8 months), due primarily to volatility in the wholesale market in Ontario, Canada.¹³ Ontario retains a competitive market for consumers who prefer to choose a provider and non-regulated price. Regulated prices are provided as the default by the local utility – a vertically integrated distributor-retailer. The regulated prices are adjusted every 6 months by the regulator, taking into account considering the wholesale market forecasts, any accumulated differences between the amount paid to generators and the amount paid by consumers for electricity.¹⁴ KPMG note that the low regulated price along with strong consumer protections have limited the ability of competitive providers to acquire new customers. Before the price re-regulation, 25 percent of consumers switched to a competitive provider, however this has fallen to 6 percent.¹⁵ Consumer awareness of private providers is also low and competitive providers have limited incentives to offer new products and services - due to the downward pressure of regulated pricing on market prices – resulting in low market activity.

Despite the regulated default price, around one third of customers with a competitive supply are not aware that they are on a competitive contract.¹⁶ These consumers are often lower income, are less likely to have a university degree and are less confident when it comes to entering into a contract.¹⁷

⁸ James Plunkett, 'Capping energy bills won't kill competition', *We are Citizens Advice*, 24 April 2017. <https://wearecitizensadvice.org.uk/capping-energy-bills-wont-kill-competition-9b55dd8213d7>

⁹ Ibid.

¹⁰ Adam Vaughan, 'Plans to cap domestic energy bills 'weak and confused', says watchdog', *The Guardian*, 27 February 2017. <https://www.theguardian.com/money/2018/feb/26/plans-to-cap-domestic-energy-bills-weak-and-confused-say-mps>

¹¹ CMA, *Press release - CMA sets out energy market changes*.

¹² Chapman, 'Energy price cap triggers mixed reactions from consumer groups', *The Independent*.

¹³ KPMG, *Energy retail markets*, 98.

¹⁴ Ibid., 41

¹⁵ Ibid.,

¹⁶ Ibid., 101

¹⁷ Ibid.

- **Price monitoring and safety net mechanisms**

The Netherlands has a relatively mature competitive retail energy market, with a relatively diverse range of offers – consistently ranked among the most competitive in Europe.¹⁸ Retailers are required to submit their tariffs to the regulator for small scale users, to assess the reasonableness of the offer - whether the contracting conditions and tariff price are fair, even taking account of a higher service quality when considering higher prices.¹⁹ The regulator also maintains the power to set maximum prices for residential electricity and gas, however the regulator has not yet exercised this power. Where the retailer considers a retailer's tariff(s) to be unfair, they can set a maximum tariff for that retailer. The regulator requires several retailers to provide explanation about their tariffs on an annual basis, which can result in some retailers being required to readjust their tariffs.

Like Victoria, the Netherlands has rolled out smart meters, and this led to some novel price structures, including prices linked to wholesale market conditions - some of which drop with higher wind speeds, others are bundled with smart thermostats.²⁰ Notably, the Dutch regulator provides a number of tools to enable consumers to compare offers, ensures transparency of information from retailers and conducts campaigns to remind consumers to regularly review their energy.

Belgium also operates a form of safety net regulation to address price volatility and pricing complexity methodologies employed by retailers. Market offers with a variable pricing structure are indexed, checked against a set of criteria developed by the regulator and subject to regulator supervision. The regulator also compares Belgian prices with neighbouring countries. KPMG note that since the introduction of the mechanism, market concentration has decreased while switching rates have increased.²¹

- **Special tariffs for vulnerable consumers**

The French retail energy market is notably less competitive than others described here, with 99 percent of the market share captured by the three largest retailers, and 88 percent of customers still on a regulated tariff (at the end of 2015).²² Moreover, though regulated prices are already relatively low, the French market also includes special tariffs are provided for households with an income below or equal to the threshold of entitlement to supplementary health cover. It is estimated that 4.5 million households are on this social tariff.²³

2. Design considerations for a Basic Service Offer or alternate price intervention tool

In the development and design of any price intervention tool, it is critical that policymakers clearly articulate the intended outcome of any intervention from the outset. This includes consideration and definition of the group of consumers impacted by the intervention and the intended outcome or behaviour change as a result of the intervention.

¹⁸ Ibid., 47.

¹⁹ Ibid., 81

²⁰ Ibid., 84

²¹ Ibid., 48.

²² Ibid., 63

²³ Ibid., 64.

For example, the intended outcome of the development of a Basic Service Offer could include:

- To develop regulated below marginal cost product *available* to all customers at all times, requiring active engagement by consumers to *procure* the product;
- To develop a reference price (for example, a signpost or reference point of the average rates available across the market) to signal to consumers if they are currently on a plan which is below or above the market average, thus 'nudging' consumers to secure a better plan;
- To develop a backstop product at a 'fair' or 'market average' price which consumers would have access to if they do not engage and make an active choice in the market within X number of years;
- To develop a low cost, 'no frills' automatic default product which requires no active engagement and which is made available to vulnerable consumers.

Intended groups of customers to be impacted by the reform should also be defined, such as:

- All consumers
- Disengaged consumers (potentially defined as not having made an active choice in the market over X number of years)
- Vulnerable consumers (potentially defined as customers participating on hardship programs, receiving an URG or a concession, or those with low household incomes)

The behavioural considerations of the intervention also include:

- Whether the reform requires consumers to make an active choice and take steps to secure a product;
- Whether the reform will deliver a default for consumers, thus not requiring an action to be taken.

Where actions are to be taken to acquire a product, CPRC supports the Victorian Government making this process as simple and effective as possible as per the feedback provided in the next section.

The product features of what is considered 'basic' or 'no frills' should also be defined, examples include:

- A product with the greatest protections for consumers, available for consumers with outstanding debt or participating on retailer hardship programs;
- A product removing inappropriate features (such as pay on time discounts and other conditionality requirements);
- A product removing the cost of retail competition (such as marketing & acquisition costs, but may or may not include conditionality or added protections).

Each intervention (outlined at Appendix - Table A) will likely have differing distributive impacts across the customer base, depending on the approach taken. CPRC supports the ESC and Victorian Government undertaking further modelling –

specifically demographic analysis - to better understand the current demographic distribution of retail products across the customer base.

At a minimum, in line with CPRC's conceptual framework and the first precondition of removing barriers for vulnerable and disadvantaged consumers, CPRC would support the development of a basic, low cost offer for vulnerable consumers in Victoria.

Similarly, CPRC strongly supports the introduction of an obligation for all energy retailers to have an offer available in market at all times for all consumers. This obligation to offer would ensure that 'high risk' or vulnerable consumers are not refused access by a retailer to an energy product as a result of their financial or other position – a possible consequence of increasing data amalgamation and consumer profiling.²⁴ The obligation to offer plan could well be required through the existing standing offer as a backstop plan, or a Basic Service Offer, depending on how this is designed.

If you have any queries about this submission, please don't hesitate to contact Research & Policy Officer, Ben Martin-Hobbs on ben.martinhobbs@cprc.org.au or (03) 9639 7600.

Yours sincerely,



Lauren Solomon

Chief Executive Officer
Consumer Policy Research Centre

²⁴ Australian Competition and Consumer Commission, 'Retail Electricity Pricing Inquiry: Preliminary Report', 22 September 2017, 143.

Appendix - Table A - Examples of design considerations for a Basic Service Offer or similar alternative

	Target customer group	Intended consumer behaviour change	Intended product outcome	Policy considerations
A Basic Service Offer below retail cost product (ex. marketing & acquisition costs)	All - engaged	Consumers engage to request Basic Service Offer from retailers.	All (or significant proportion?) of engaged consumers secure a Basic Service Offer product lower than retail cost of delivery.	<ul style="list-style-type: none"> • Still requires engagement to procure product. • Impact on solar, battery and new technologies if significant proportion of customer base acquires a flat product. • Impact on competition – no marketing/acquisition costs. • Distributional impacts across the customer base if this drives prices & products to converge around the BSO (e.g: impact on consumers who currently receive a heavy discount such as concession or customers on hardship programs)
Basic Service Offer reference price	All - engaged	'Signalling' and 'Nudging' consumers to engage and secure an offer better than the published Reference Price.	More consumers engage to secure a product that suits their needs.	<ul style="list-style-type: none"> • Would need to be based on evidence of consumer behaviour – where would the reference price need to be published? When are consumers most engaged (when they receive a bill)? What channel is most effective (sms, bill, letter, email)? • Simple, low time cost pathway developed for consumers to secure a better product (e.g: through VIC Energy Compare, or calling energy retailers). • How to manage different costs across distribution regions • Does this include ToU or demand pricing?
Fair automatic default Basic Service Offer for disengaged consumers	All - disengaged	None – consumers automatically placed on product.	For all consumers that have not engaged in the energy market to secure a fair plan in X years, they will be automatically rolled onto a backstop product.	<ul style="list-style-type: none"> • Does this encourage further disengagement from energy consumers? • Impact on competition? • Are customers being moved from a plan that suits their needs to a plan which does not? • Impact on innovation – solar, battery households etc?
Automatic low-cost default Basic Service Offer for vulnerable consumers	Vulnerable consumers (for example: customers participating on hardship programs, receiving an URG or concession).	None – consumers automatically placed on product.	Vulnerable consumers secure access to an affordable product at all times.	<ul style="list-style-type: none"> • How to define vulnerable consumers (hardship program participation, URGS, concessions, income bands) • Impact and benefit to concessions budget (if lower cost plans are offered, the DHHS saves on payments made at 17.5%) • Potential exclusions (e.g.: concession households with solar panels).