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RETAIL ELECTRICITY PRICES REVIEW - Determination of default market offer prices

ABOUT US

Set up by consumers for consumers, CHOICE is the consumer advocate that provides Australians with information and advice, free from commercial bias. CHOICE fights to hold industry and government accountable and achieve real change on the issues that matter most.

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Australians need affordable, safe energy offers

The energy market is failing. People struggle to navigate a sea of complex offers to find a deal that meets their needs and their budget. The cost of energy has long been a key concern for households and continues to rank ahead of any other household expenditure concerns in CHOICE's quarterly Consumer Pulse Survey.¹ A separate CHOICE survey found that although 63 per cent of respondents felt that they were paying too much for energy, only 41 per cent felt they had sufficient information and tools available to find what's best for their household when it came to energy.²

In deregulated markets like the National Energy Market (NEM), consumers are rewarded for engaging: those who compare and contrast energy offers can save money by switching to more competitive energy deals. There is however a sizeable portion of consumers who cannot actively engage in the energy market and will not be able to compare offers and switch. This can be due to factors such as language barriers, time constraints or behavioural biases, or people may simply be overwhelmed by the complexity of the energy market. In late November 2018, there were a staggering 2227 electricity offers available to residential customers in NSW, making the task of selecting the best offer without assistance almost impossible.³

Behavioural insights research suggests that the complexity of the energy market can lead to 'information overload, which, for some consumers, can occur even if they are assessing a seemingly manageable amount of information, as they may fail to discern which information is important or ignore some of it altogether.'⁴ It is crucial to ensure that consumers who cannot engage with the energy market still have access to affordable energy and are protected from retailers' predatory practices.

Standing offers were designed as a safety net to ensure that everyone could access electricity services. These offers were set up under the assumption that consumers could shop around for a more competitive market offer if they chose to, but would be protected if they did not exercise this choice.⁵ The industry-held view that standing offers should be the most expensive offers on the market⁶ undermines the purpose of these offers and penalises people who do not, or cannot, choose a market energy offer.

¹ CHOICE Consumer Pulse is a nationally representative survey conducted quarterly since June 2014. Final data has been weighted to ensure it is representative of the Australian population based on ABS Census data.

² CHOICE (2015), *Energy Survey*, Sydney. Research was conducted in December 2015 with 1039 respondents aged between 18-75 years. The sample was nationally representative of the Australian population, based on 2011 ABS data

³ MI Retail Energy, '*MI Statistics*', accessed 27 November 2018.

⁴ Australian Energy Market Commission (2016), [Behavioural insights into Australian Energy Markets](#), prepared by Oxera, Sydney, p18

⁵ Australian Energy Regulator (2015), [Retail Pricing Information Guidelines](#), Melbourne, p4

⁶ Australian Energy Market Commission (2018), [Consultation Paper: National Energy Retail Amendment \(Preventing discounts on inflated energy rates\)](#), Sydney.

Safe default offers are needed to protect everyone but particularly disengaged consumers from high energy prices. These offers are also necessary to protect consumers who cannot access market offers due to poor credit history and must resort to using standing offers. Safe defaults must be available to everyone in a deregulated market, whether they choose to access them voluntarily or default onto them in circumstances where they have not made a choice to sign up to a market offer. The introduction of new safe default offers should be driven by clear, consumer-centric outcomes, and should lead to the creation of fair and affordable energy offers and significant reductions to consumers' energy bills.

CHOICE is calling for the introduction of a safe default offer that is:

- affordable, with a capped price
- available to everyone in a deregulated market
- free from excessive marketing costs
- a safety net when a customer has not chosen an energy offer, or their previous contract has expired

CHOICE's support for safe defaults is echoed by 6,101 CHOICE supporters who have written to the Federal Energy Minister to call for fair, affordable and accessible default offers.

Recommendations

1. That the AER should, in the long-term, take a cost-based bottom-up approach to determining default offer prices.
2. That the AER should cap retail margin in the calculation of the default offer price.
3. That the Federal Government grants the AER powers to develop rules preventing retailers from keeping customers on evergreen market contracts.
4. That when selecting tariff types to which the default market offer will apply, the AER takes an approach that makes the default offer accessible to as many households as possible. The regulator should give greater consideration to developing a default offer that is available for time of use tariffs, in addition to the suggested flat-rate and controlled-load tariffs to suit customers with smart meters installed.
5. That the AER ensure that the default price will also deliver fair outcomes to households who use solar.
6. That in addition to the annual review of default offer prices, the AER schedules a three-year review of the default offer determination process to ensure that it is facilitating the delivery of fair and affordable electricity.

- As part of this review, the AER should assess whether the tariff types to which default offer prices will apply are suited to consumer needs.
7. That the AER undertakes additional consumer comprehension testing to determine how a dollar amount on a reference bill is displayed to help customers compare and contrast offers effectively.

Setting the price of default energy offers

The need for a bottom-up approach to set default offers

Recommendation 30 from the ACCC's Retail Electricity Pricing Inquiry⁷ is cited as the basis for the introduction of the default market offer. This recommendation calls for standing offers to be abolished and replaced with default offers that are required to be at or below the price set by the AER. The ACCC's recommendation suggested that the price set by the regulator 'should be the efficient cost of operating in the region, including a reasonable margin as well as customer acquisition and retention costs.'⁸

In the AER's Default Offer Price Draft Determination, the AER has departed from the approach recommended by the ACCC. Instead of representing the efficient costs of operation, under the AER default offers will instead 'act as a cap on the price of default offers to limit the 'loyalty tax' that is levied on disengaged consumers.'⁹ This proposed mechanism is too similar to the design of existing standing offers and does not effectively communicate the actual costs of providing energy as an essential service to consumers. This approach will be less effective at driving down costs and achieving fair default offer prices than what was put forward by the ACCC.

The design of the default offer should deliver significant cost savings to consumers by preventing retailers from overcharging households for energy. The AER's approach of calculating the default offer from existing market prices, is fundamentally flawed given the broken nature of the current market.

Basing the default offer price on the prices that retailers have set themselves without undertaking detailed analyses of retailers' efficient operating costs does not take into account high retail margins. This means that the default offer will be calculated using data gathered from a broken energy market that is already gouging consumers. Calculating a default offer by using data on inflated energy offers is not a suitable approach in the long-term for determining fair and affordable energy offers.

⁷ ACCC (2018), Retail Electricity Pricing Inquiry - Final Report, Melbourne, p252

⁸ Ibid.

⁹ Australian Energy Regulator (2019), [Retail electricity prices review - Determination of default market offer prices](#), Melbourne, p7

Basing the default offer price on current pricing structures, which include soon-to-be abolished standing offers¹⁰ and harmful conditional discounts¹¹ which are due to be reviewed,¹² is unfair to consumers. These outdated pricing structures are causing harm to people. Basing default offer prices on existing standing offers and market offers with conditional discounts is not an effective way to determine fair and affordable energy prices.

CHOICE again suggests that the AER take a cost-based bottom-up approach to determining default offer prices. This would allow for the AER to estimate the main cost components of a bill in order to determine a default price. The AER's proposed top-down approach would set a range for default offer prices by assessing observed market prices and identifying both the median market offer (to determine the lower limit) and the median standing offer (to determine the upper limit). This range is representative of a market that is not delivering good outcomes for consumers and relies on market participants' own expectations about the efficient costs of providing electricity services in particular distribution zones. A bottom-up approach is a more suitable method for determining the efficient costs that a retailer would incur in a confusing market with enormous price dispersion between electricity offers.

Defining a reasonable retail margin

If a 'reasonable retail margin' is to be included in calculating the default offer, this term must be clearly defined in order to guarantee the affordability of default offers. The recommendation to 'include a reasonable margin' runs the risk of being exploited by industry.¹³ It is important to note that consumers are on average paying a retail margin that is more than double what it was 10 years ago in dollar terms.¹⁴ Excessive retailer margins are contributing to expensive energy bills that consumers are struggling to pay, and the default offer should not enable the continuation of this practice.

Exploitative evergreen contracts need to be addressed

CHOICE also recommends that the Federal Government grants the AER powers to develop rules that prevent retailers from keeping customers on evergreen market contracts. Many market contracts continue indefinitely beyond the point at which a customer's benefits have expired. There is currently no requirement to switch these customers to a safe default, so they will remain on an overpriced market contract until they make an active choice to switch. The

¹⁰ Ibid. p38

¹¹ Ibid. p37

¹² Australian Energy Market Commission (2019), [Improving consumer outcomes and competition by regulating conditional discounting](#).

¹³ ACCC (2018), Retail Electricity Pricing Inquiry - Final Report, Melbourne, p252

¹⁴ ACCC (2018), Retail Electricity Pricing Inquiry - Final Report, Melbourne, p6

AER acknowledges that under the draft Code the default offer price will not apply to customers who are on evergreen ongoing market contracts where discounts have expired, and who in practice are paying a retailer's standing offer prices.¹⁵ This means that a large portion of disengaged consumers whose benefits have expired will not benefit from the default offer price.

While switching rates are on the rise, the Australian Energy Market Commission's *2018 Retail Energy Competition Review* shows that only 16 per cent of South Australian customers and 19 per cent of NSW customers switched energy providers in the last year.¹⁶ Only 58 per cent of customers in the NEM were confident they could make good decisions when it came to choosing their energy offer.¹⁷ These figures suggest that finding and signing up to an affordable energy plan is still a challenge for consumers in a complicated energy market, and that many consumers still experience inertia and remain on existing energy contracts after their benefits have expired. A mechanism needs to be developed to switch these customers to safe default offers in order to prevent them from being penalised for not engaging with the energy market. CHOICE acknowledges that recent changes have been made to ensure that customers are notified when their benefits expire but education alone is not enough. Retailers must be required to switch customers to safe default offers to prevent households from being exploited through nefarious bait and switch behaviour.

Recommendations 1, 2 and 3

1. That the AER should, in the long-term, take a cost-based bottom-up approach to determining default offer prices.
2. That the AER should cap retail margin in the calculation of the default offer price.
3. That the Federal Government grants the AER powers to develop rules preventing retailers from keeping customers on evergreen market contracts.

Ensuring that the benefits of default offers are realised

The percentage of customers on standing offers in deregulated markets in the NEM is relatively small, ranging from as little as six per cent of Victorian households,¹⁸ to as high as 16 per cent in South Australia.¹⁹ The design of the default offer should deliver significant cost savings to

¹⁵ Australian Energy Regulator (2019), [Retail electricity prices review - Determination of default market offer prices](#), Melbourne, p18

¹⁶ Australian Energy Market Commission (2018), *Retail Energy Competition Review*, Sydney, pp96-97

¹⁷ Ibid. pvii

¹⁸ ACCC (2018), [Retail Electricity Pricing Inquiry - Final Report](#), Melbourne, p12

¹⁹ Ibid. p18

consumers on existing standing offers and provide an opportunity for consumers on market contracts to switch to an affordable energy offer with maximum consumer protections.

Consumers charged on time of use and demand tariff types will miss out on accessing the benefits of a default offer. CHOICE recommends that when selecting tariff types to which the default market offer will apply, that the AER takes an approach that makes the default offer accessible to as many households as possible. The regulator should give greater consideration to developing a default offer that is available for time of use tariffs in addition to the suggested flat-rate and controlled-load tariffs to suit customers with smart meters installed. The AER must also ensure that the default price will deliver fair outcomes to households who use solar.

While there are challenges in estimating default offers and reference bills for different tariff structures, this should not mean that cohorts of consumers are excluded from the benefits and protections that a default offer provides.

The regulator should ensure that the effectiveness of default offers is reviewed on a regular basis. CHOICE recommends that in addition to the annual review of default offer prices, the AER schedules a three-year review of the default offer determination process to ensure that it is facilitating the delivery of fair and affordable electricity. As part of this review, the AER should assess whether the tariff types to which default offer prices will apply are suited to consumer needs.

Recommendations 4, 5 and 6

4. That when selecting tariff types to which the default market offer will apply, the AER takes an approach that makes the default offer accessible to as many households as possible. The regulator should give greater consideration to developing a default offer that is available for time of use tariffs, in addition to the suggested flat-rate and controlled-load tariffs to suit customers with smart meters installed.
5. That the AER ensure that the default price will also deliver fair outcomes to households that use solar.
6. That in addition to the annual review of default offer prices, the AER schedules a three-year review of the default offer determination process to ensure that it is facilitating the delivery of fair and affordable electricity.
 - As part of this review, the AER should assess whether the tariff types to which default offer prices will apply are suited to consumer needs.

Using default offer prices as a reference bill

A major benefit of default offer pricing is that ‘it will be used to set a reference bill amount which all discounts must be calculated from.’²⁰ Safe default offers and honest advertisement of discounts go hand in hand. By requiring all discounts to be calculated from a reference price, the AER has the potential to radically improve consumer experiences in the energy market by addressing energy affordability and reducing complexity.

CHOICE is also supportive of using default offers to develop reference bills that ‘would function as a benchmark comparison point, against which consumers could compare the relative price of different offers.’²¹ The default offer should be designed to give consumers an indication of the efficient operating costs of a retailer, and therefore provide consumers with a better understanding of fair energy prices. However, the AER’s proposed method of determining default offers will not be representative of an efficient energy price, and will not help consumers compare market offers against a fair default offer price. This is why it is essential that the AER take an alternative approach to setting default market offers, as proposed above.

Recommendation 7

7. That the AER undertakes additional consumer comprehension testing to determine how a dollar amount on a reference bill is displayed to help customers compare and contrast offers effectively.

²⁰ Australian Energy Regulator (2019), [Retail electricity prices review - Determination of default market offer prices](#), Melbourne, p18

²¹ Ibid. p10