# Economic consequences of the Victorian Default Offer

## Executive summary

Standard economic analysis of the Victorian Default Offer (VDO) as proposed in the Draft Advice provided by the Essential Services Commission yields a number of conclusions that should be of concern to policy makers. These conclusions are as follows:

1. By eliminating the ability of electricity retailers to achieve a basic level of profit the VDO will drive some retailers out of the market and prevent others from entering it in the future.

2. As a matter of deliberate design, the VDO seeks to eliminate cross subsidies to price-sensitive customers, including vulnerable customers, who have engaged with their retailer and currently enjoy cheaper rates.

3. Customers on offers currently cheaper than the VDO can only lose from the introduction of the VDO; they cannot win.

4. The VDO, with its failure to allow for headroom, will transfer high electricity prices from some current customers to most future customers.

5. A VDO that included an allowance for headroom would closely resemble the Default Market Offer (DMO) being developed by the Australian Energy Regulator (AER).

6. If the Victorian Government wishes to proceed with the regulation of retail electricity prices, the DMO would have less adverse consequences than the VDO by: enabling cross subsidisation among customers to the benefit of engaged customers, including vulnerable customers; permitting more competition in the existing market; and allowing the entry of new competitors in the future.

7. The more closely the VDO approximates the DMO, the lesser will be the adverse consequences of the VDO for engaged customers, including vulnerable customers, and for competition and innovation.

It is recommended that the ESC and the Victorian Government delay consideration of the VDO and work with the Commonwealth on the design and implementation of the DMO.

## Introduction

A proposed methodology for determining the Victorian Government's default price for electricity is set out in Draft Advice released by the Essential Services

Commission (ESC). This report analyses the economic impacts of the Victorian Default Offer (VDO) as proposed in the Draft Advice.

In particular, the report examines the following:

- Is it reasonable for the ESC to assert that customers on offers below the median market offer will not be disadvantaged?
- Would a VDO in line with the ESC's Draft Advice transfer risk from disengaged customers to engaged customers?
- What is the likely impact for vulnerable customers who have engaged with their retailer and currently enjoy cheaper rates?
- What will be the likely impact on customers of the loss of a number of small retailers from the market?
- What might represent a fairer price that balances the costs for disengaged customers while reducing the risks for engaged customers?
- What could constitute a lower-risk approach to setting the VDO?
- What are the risks of using different methodologies to determine each element of the cost stack?

## Basic analysis

This report deploys standard economic analysis in answering these questions. Economic analysis tells us that consumer welfare is maximised in a perfectly competitive market with perfect information (and correspondingly, no search costs) and no externalities (such as pollution). In this perfectly competitive market, the interaction of producer supply and consumer demand yields an equilibrium price and an equilibrium quantity supplied.

At those equilibrium prices and quantities in a perfectly competitive market, total consumer welfare is maximised. Total consumer welfare in the market is the difference for all consumers between the price they are willing to pay for the product or service they buy and the price they actually pay. To the extent that the price they actually pay is less than the price they are willing to pay, they enjoy a consumer surplus. The total consumer surplus of all consumers in the market is consumer welfare.

Where markets are not perfectly competitive, governments commonly intervene in an effort to correct for the imperfections, or for other purposes including income redistribution.

The introduction of a government regulation into a market inevitably will have economic impacts. Some impacts might be positive for consumer welfare while

others are likely to be negative. Whether the impacts overall are positive or negative will depend on both the nature and the size of the intervention.

A large, inefficient intervention in an imperfect market is more likely to be negative for consumer welfare while a modest, smaller intervention conceivably can yield an overall gain. An efficient regulation will target the specific cause of the market imperfection and will be of a size that does not over-correct for the market imperfection, and so avoids wider impacts that are detrimental for consumer welfare. A regulation that only indirectly addresses the specific market imperfection, by reducing supplier revenues, will have the intended or unintended consequence of restricting existing supply and/or creating barriers to entry.

The ESC seeks to utilise orthodox economic theory by referring to the notion of "a highly efficient retail electricity market" within which "customers are highly engaged" such that they "would not tolerate prices that were not cost reflective:"

> *"They would switch away from any retailer who tries to raise prices above the efficient cost of providing the service to them. As a result, prices across the entire market would converge on the efficient cost of providing electricity services" (p. iii-iv).*

The efficient price to which the ESC refers is related to the equilibrium price in a perfectly competitive market.

However, the ESC goes on to describe this efficient price in the following terms:

> *There would be no headroom in prices and no cross-subsidies between different groups of customers. We believe this is the "fair" price that the VDO is intended to make available to customers" (p. iv).*

The Thwaites-Mulder-Faulkner report (Thwaites, Mulder and Faulkner 2018) defines headroom as "an allowance that is often added to regulated retail energy prices so that regulated retail prices do not act as a barrier to entry for new retailers" (p. 64). It is a component of the price that attracts new entrants into a market. The ESC confirms its intention in disallowing headroom in the VDO:

> *"In this context, the term headroom refers to a regulatory allowance that is unrelated to efficient costs. In other words, the terms of reference make clear that retailers should not earn excess returns (or profits) from customers on the VDO" (p. 11).*

What are excess profits? Firms in a competitive market are able to earn normal profits but not supernormal profits. Normal profits are those just sufficient to attract and retain firms in the market. If supernormal profits appear, say through a technological breakthrough, more firms will enter the market and, by competing with each other and with existing firms, will drive down the supernormal profits to the point where only normal profits remain. But these

normal profits are essential; without them there is no incentive for new firms to enter the market.

In less than perfectly competitive markets, supernormal profits can persist. They can take the form of various types of rent, such as resource rents, land rents, monopoly rents and oligopoly rents. Governments can legitimately intervene to correct for these supernormal profits. However, governments should not seek to reduce or eliminate normal profits, since these are essential to the functioning of an efficient market.

The ESC's proposed VDO does exactly that; it seeks to eliminate normal profits. The ESC's VDO is a regulated price, which will be set below the various retailers' standing offers; that is, the VDO effectively is a price ceiling. The ESC has advised that customers on standing offers will be automatically transferred to the VDO from 1 July 2019 and retailers will be obliged to advise customers that the VDO is available if their market offer is above the level set for the VDO. Consequently, retailers can be expected to reduce their market offers to no more than the VDO.

In standard economic analysis, while a price ceiling will make some existing consumers better off, inevitably it will reduce supply, resulting in a loss not only to producers but to consumers as well.

If a price ceiling is imposed, existing consumers on standing offers will be able to buy electricity at that lower price. But in the longer run, consumers will be made worse off by the departure from the market of some suppliers and by the inability of new suppliers to enter the market and provide competition to the remaining suppliers.

The effect is the same as that of rent control: it is good for existing tenants, bad for landlords but, in the long run, bad for both landlords and tenants, as the supply and quality of rental accommodation falls. The same goes for regulating the price of petrol and supermarket items. If price ceilings were such a good idea, with no adverse consequences for consumers, prices would be regulated throughout the Australian economy.

By excluding headroom from the regulated price, the ESC's proposed VDO removes the incentive for some firms to remain in the market and for prospective competitors to enter the market. A firm considering entering a market will incur fixed costs such as buildings, plant and equipment whereas existing firms can remain in a market as long as they are able to cover their variable costs such as wages fuel and maintenance. However, if they are not permitted to earn normal profits, when it comes time to incur new fixed costs such as refurbishments and the acquisition of modern, new equipment, they will not have an incentive to remain in the market.

If the market imperfection that the ESC is seeking to rectify is that of imperfect information leading to significant consumer search costs, then the most appropriate intervention is to reduce or eliminate search costs. For example, the Victorian Government's website that provides comparisons of the various tariffs

offered by the different retailers could be promoted more vigorously and made as easy to understand as possible.

***By eliminating the ability of electricity retailers to achieve a basic level of profit the VDO will drive some retailers out of the market and prevent others from entering it in the future.***

## Is it reasonable for the ESC to assert that customers on offers below the median market offer will not be worse off?

Retailers use income from their market offers above the median offer to subsidise customers on offers below the median offer, as well as to contribute towards their overall profits. Offering the same product to different groups of customers at different prices is rational economic behaviour and can be beneficial to customers.

Consider the example of movie tickets. It is common for cinemas to offer different prices to different groups of moviegoers. Typically, adults are charged higher prices than pensioners and students. These prices are based on the willingness to pay of different types of customers. Generally speaking, adults on average are willing to pay more for movie tickets than pensioners and students. In paying more for movie tickets, adults are cross-subsidising pensioners and students.

If a regulator imposed a price ceiling on tickets for adult moviegoers, adults might be happy initially, but ticket prices for pensioners and students would rise. Since this would reduce the demand for tickets from pensioners and students, supply of movie sessions would be reduced, restricting choice for adult moviegoers. In the end, pensioners and students, as well as adults looking for a wide choice of movie times, would all be worse off.

In the case of electricity retailing, the imposition of a price ceiling in the form of the VDO would reduce the income from standing offers, restricting retailers' ability to cross-subsidise customers on lower-priced offers.

A further example is a 2008 proposal to regulate fuel prices. In 2008, the Rudd Government sought to introduce Fuel Watch. Fuel retailers would be obliged to post a price each day and maintain that price for at least 24 hours. The stated aim of Fuel Watch was to reduce the variability in petrol prices: in particular, to dampen the weekly fuel price cycle.

***Motorists told pollsters they disliked the fuel price cycle, but they were never asked whether they would be willing to pay higher prices in order to smooth out the cycle.***

The ACCC estimated that the introduction of Fuel Watch could reduce the average price of petrol by 0.7 cents per litre. Cost-conscious motorists in outer-suburban areas had been taking advantage of the fuel price cycle by filling up on what was then known as 'cheap Tuesday.' On that day, prices were usually well

below the average price. Well-off motorists – those from affluent suburbs, and executives given fuel cards as part of their remuneration packages – were not price conscious. They did not care whether they filled up on cheap or expensive days.

The distributional effect of Fuel Watch would have been to raise prices for those who cared most about fuel prices and lower them for those who cared least. The small expected reduction in the average price would not have benefited low-income motorists, since, for them, the price would have risen.

The VDO proposal is analogous to Fuel Watch. Cross subsidies from the well off to the poor would be eliminated or greatly reduced, increasing prices for the least well off and reducing them for the better off.

***Customers on offers below the median market offer inevitably will be worse off under the VDO.***

The ESC seems to acknowledge this in commenting on the terms of reference given to it:

> *"Finally, we note that the background section of our terms of reference states that the VDO will be made available to customers "without impeding the consumer benefits experienced by those who are active in the market." We understand this statement to be an articulation of policy intent — that is, that the VDO is not intended to be a single, mandatory price to the exclusion of all others. Retailers will not be prohibited from making other offers available to customers, leaving customers free to enter these alternative contracts if they represent good value for money (even if they cost more than the VDO).*
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> *"On this basis, we have interpreted the reference to not impeding customers who are active in the market as a statement of policy design rather than a factor which we must take into account when developing a pricing methodology" (p. 12).*

The ESC seems to accept that the VDO will have an adverse impact on engaged customers, choosing to interpret the terms of reference as a statement of policy design rather than a factor that must be taken into account in developing the methodology for the VDO.

## Would the ESC's Draft Advice transfer risk from disengaged customers to engaged customers?

Engaged customers search for lower electricity tariff offerings. While engaged customers will include people earning higher incomes who choose to shop around for the best deals, many low-income earners facing cost-of-living pressures are in the group of engaged customers. Other things being equal, low-income earners will have a lower willingness to pay for electricity than higher-income earners.

Analysis by the ACCC (2018, Figure 12.5) has confirmed that hardship customers are under-represented in the group of customers on standing offers, especially in Victoria, with only 4 per cent of hardship customers in Victoria being on standing offers in mid-2017. Subsequently, retailers agreed with the Federal Government that they would contact hardship customers remaining on standing offers and offer them a better deal.

By placing too much focus on reducing retailers' incomes from their standing offers, the VDO will reduce the ability of those retailers to cross-subsidise engaged customers, including concession-card holders.

The ESC points out that only 6 per cent of Victorian households and 15 per cent of small businesses are on standing offers,[1] which limits the amount of cross subsidy and therefore the risk to engaged customers. Nevertheless, the VDO will transfer risk from existing disengaged customers, who will pay lower tariffs than the standing offer rates, while increasing the risk that engaged customers will pay higher tariffs than their current rates.

The VDO is designed to reduce the profitability of retailers that have customers on standing offers. Since the VDO makes no allowance for headroom and the ESC is taking a conservative approach in determining the various cost components, especially customer acquisition and retention costs (CARC), the VDO must have flow-on consequences. Indeed, the ESC explicitly rules out cross subsidies to engaged customers, including vulnerable customers, who currently enjoy cheaper rates:

> *There would be no headroom in prices and no cross-subsidies between different groups of customers. We believe this is the "fair" price that the VDO is intended to make available to customers" (p. iv).*

***As a matter of deliberate design, the VDO seeks to eliminate cross subsidies to customers who have engaged with their retailer, including vulnerable customers, and currently enjoy cheaper rates.***

The establishment of a VDO runs the substantial risk that vulnerable engaged customers and new vulnerable customers who otherwise would become engaged will assume that the VDO is the best available offer. The ACCC has highlighted this risk in respect of the Basic Service Offer (BSO) recommended by the Thwaites-Mulder-Faulkner review (2018), but the same risk applies but to the VDO:

> *"Implementing a BSO would also likely have an impact on consumer behaviour. Research conducted on behalf of the ACCC in relation to the experiences of international jurisdictions indicates that, in jurisdictions with price regulation, consumers tend to remain on the regulated offers and do not*

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[1] Essential Services Commission, "Energy regulator puts Victorian Default Offer on the table," Media release, 8 March 2019.

*participate in the market. The ACCC considers that if a BSO were implemented in Victoria or the NEM more broadly, many consumers would take the BSO knowing that they were on the best (or one of the best) available offers, and no longer consider it necessary to engage" (pp. 250-251).*

If, as the ACCC states, international evidence indicates that vulnerable, engaged customers will assume the regulated price is the best on offer, it is likely that many will assume the VDO is the best available tariff and will select it over cheaper offers.

***Vulnerable, engaged customers can only lose from the introduction of the VDO; they cannot win.***

## The likely impact on customers of the loss of a number of small retailers from the market

In addition to redistributing disposable income from existing disengaged customers to existing engaged customers, the ESC's VDO will have inter-temporal redistributive effects. By making no allowance for headroom and taking a conservative approach to other components of the cost stack, particularly CARC, the VDO will drive a number of small retailers from the market. While the small retailers most likely to leave the market are the higher-cost ones, these might well include relatively new entrants trying new tariff structures and new technologies.

Moreover, in making no allowance for headroom, which is defined as an allowance designed to ensure regulated retail prices do not act as a barrier to entry for new retailers, the VDO will constitute a barrier to entry for future retailers. As some existing retailers exit the market and new retailers are prevented from entering it, future customers will pay higher electricity prices while existing customers on standing offers will pay less.

Pointedly, the ESC explains in its Draft Advice that it is obligated to ensure there are incentives for competition and long-term investment:

*"Section 8(1) of the ESC Act states, "the objective of the Commission is to promote the long term interests of Victorian consumers." Section 8A lists a number of matters to which the commission must have regard "to the extent that they are relevant in any particular case". We consider the three most relevant matters regarding this draft advice are sections 8A(1)(a)-(c), namely:*

*(a) efficiency in the industry and incentives for long term investment;*

*(b) the financial viability of the industry; and*

*(c) the degree of, and scope for, competition within the industry, including countervailing market power and information asymmetries" (p. 10).*

In making no allowance for headroom, as dictated in the terms of reference given to it, the ESC arguably is in contravention of the ESC Act.

The ACCC (2018) was highly critical of this aspect of BSO proposed by the Thwaites-Mulder-Faulkner review.

> *"The ACCC is concerned that implementing a BSO would lead to reduced innovation and act as a disincentive to retailers to adopt new technology or service models. Competition drives such incentives and provides benefits for consumers with new products and improved processes. The retail electricity market is undergoing substantial changes, providing many opportunities for new and improved products and services to be delivered to consumers. It is therefore critical that this opportunity is not foreclosed. While the number of suppliers in the market should not, of itself, be an objective to pursue and protect, the ACCC is of the view that many smaller retailers in this market are at the forefront of innovation and provide improved offerings to consumers"* (pp. 250-251).

Instead of the BSO, the ACCC recommended a default price that includes an allowance for headroom. The Australian Energy Regulator (AER) is developing the ACCCs default price as the Default Market Offer (DMO). The ESC acknowledges the differences between the VDO and the DMO:

> *"The DMO appears to tolerate some headroom and cross-subsidies between customers ... we have found that if we took the AER's methodology but made no allowance for headroom, the DMO and VDO would produce very similar prices" (p. 4).*

The ACCC considers that, in driving competitors from the market and restricting the entry of new competitors, the BSO would inhibit consumer choice:

> *"The ACCC agrees with the AEMC's view that while the benefits of competition and price deregulation in the NEM have not materialised for a number of consumers, competition is clearly benefiting those who are engaging in the market and finding deals that suit their circumstances. We do not want to inhibit these consumers from achieving good outcomes.*
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> *"The ACCC considers that electricity markets are still developing and mature retail competition has not yet been achieved in any NEM jurisdiction. We do not consider that implementing a BSO is warranted at this stage and that a number of our other recommendations will provide better outcomes for consumers than price regulation. In particular, our recommendation to implement a default offer would carry with it many of the safeguard elements of a BSO, but would also retain many of the positive aspects of competition" (pp. 250-251).*

Since the ACCC's default price, which is the DMO, allows for headroom while the VDO does not, the ACCC's criticism of the BSO also applies to the VDO.

The ESC accepts that its approach in setting the VDO is inconsistent with the entry of competitors into the Victorian retail electricity market:

> *"As such, we have sought to frame how we consider the costs of running an electricity retail business by outlining a number of principles:*
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> - *Costs are based on a retail business already operating in the Victorian market not a new entrant" (p. 10).*

***The VDO is closer to the BSO than it is to the DMO. Its failure to allow for headroom will transfer high electricity prices from some current customers to most future customers.***

## What are the risks of using different methodologies to determine each element of the cost stack?

If the ESC adopts the methodology for each component of the cost stack that produces the lowest-possible VDO, the risks to engaged customers, including vulnerable customers, to competition and to innovation will be increased commensurately. Where judgements are to be made in respect of the methodology and quantification applied to any particular component of the cost stack, the ESC should err on the side of including costs rather than excluding them, in the interests of present and future engaged customers, including vulnerable customers, competition and innovation.

In particular, the ESC indicates that it is required by the terms of reference given to it that it is to make "a modest allowance for customer acquisition and retention costs (CARC)" (p. 15). What constitutes "a modest allowance" for CARC is a matter for judgment by the ESC. The ESC has taken a highly conservative approach in its methodology for calculating CARC:

> *"This paper also outlines how we have approached the task of identifying a "modest allowance for customer acquisition and retention costs" (CARC) and a "maximum retail profit margin". In identifying the appropriate allowance for CARC, we have sought to imagine what a market might look like when customers are highly engaged and willing to rapidly switching to better priced offers as soon as they became available. In this efficient market, retailers would not need to spend a great deal on marketing because customers are already heavily engaged in searching for a better price" (p. 12).*

Effectively, the ESC has assumed away search costs by creating a hypothetical world of perfect information. Obviously in these theoretical circumstances CARC will be extremely low. The ESC could adopt a more realistic approach that reflects the real world, and make a larger allowance for CARC.

## What might represent a fairer price that balances the costs for disengaged customers while reducing the risks for engaged customers?

A price that better balances the costs for disengaged customers while reducing the risks for engaged customers in the ACCC's default price, which the AER is developing as the DMO. The major difference between the VDO and the DMO is that the VDO does not make an allowance for headroom or cross subsidies whereas the DMO does. The ESC's Draft Advice (ESC 2019) acknowledges this:

> *"Soon after the Victorian government introduced its VDO legislation, the federal government released draft regulations confirming its intention to introduce a Default Market Offer (DMO) in non-price regulated jurisdictions — namely, South Australia, New South Wales and south east Queensland. At the same time, the AER released its draft proposal for how it would determine the DMO in these states.*
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> *"These terms suggest the DMO is not intended to be as profound an intervention as the VDO. The DMO appears to tolerate some headroom and cross-subsidies between customers. This explains the approach taken by the AER. The methodology outlined in its draft determination does not propose a cost-based approach like we have proposed in this paper. Instead, the AER proposes to set the DMO based on the average of the median price for standing offers and the median price for market offers. While it is not possible to draw any conclusions about whether the median price for market offers contains any headroom, there can be no doubt that the median price for standing offers will contain headroom (because standing offers are the most expensive offers in the market). The AER's methodology allows 50 per cent of this level of headroom in its estimate of the DMO.*
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> *"As reported in this paper, we have applied the AER's methodology to identify what the DMO might have looked like had it been applied in Victoria. We find that for households, the DMO could be around $200 higher than the VDO. Perhaps more interestingly, we have found that if we took the AER's methodology but made no allowance for headroom, the DMO and VDO would produce very similar prices" (p. iv).*

***A VDO that included an allowance for headroom would closely resemble the DMO with all the attendant advantages of the DMO over the VDO in terms of enabling cross subsidisation among customers to the benefit of vulnerable, engaged customers, competition in the existing market and ease of entry by new competitors in the future.***

## What could constitute a lower-risk approach to setting the VDO?

Given that the Victorian Government has decided it will introduce a default price, the best approach by far would be to re-engage through the COAG Energy Council and commit to the ACCC's national default price in the form of the DMO. Since the DMO makes an allowance for headroom and the cross subsidisation of

vulnerable customers while the VDO does not, the DMO would produce better outcomes than the VDO for most existing customers and for future customers. The DMO is more consistent with maintaining competition and innovation in electricity retailing in Victoria.

If there were a change of government in Canberra, the ALP would likely welcome Victoria into a national default price regime as recommended by the ACCC, to which the ALP has already committed. Victoria could indicate publicly that, with a more cooperative national approach, it has decided not to proceed with the VDO and instead will work with the Commonwealth on the DMO.

A second-best option would be for Victoria to stick with the VDO but effectively to make allowance for headroom and cross subsidisation to engaged customers, including vulnerable customers, by taking a less stringent approach to setting the various components of the cost stack. This would reduce the risks associated with the VDO for vulnerable customers and for competition and innovation.

The ESC notes:

> *"… the VDO would save a typical residential customer around $200 and the typical small business customer around $1,000 more than the DMO, if the VDO was not implemented. This result is likely to be driven by an allowance for headroom that is driven by the high prices under the median standing offer" (p. 78).*

***The more closely the VDO approximates the DMO, the lesser will be the adverse consequences of the VDO for engaged customers, including vulnerable customers, and for competition and innovation.***

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## REFERENCES


Australian Competition and Consumer Commission (2018), *Restoring electricity affordability and Australia's competitive advantage: Retail electricity pricing inquiry final report*, June.

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