Factsheet: Default Market Offers

A default offer is intended to be a cap on the price retailers are allowed to charge their customers currently on standing offers. Customers on standing offers are generally those who have not made a choice to enter into a market deal with their retailer of choice.

The Federal Government has tasked the Australian Energy Regulator (AER) with determining the default offer In New South Wales, South Australia, and Queensland.

In Victoria, the state government has made a similar request to the Essential Services Commission (ESC).

Both regulators have been requested to develop:

- **Default offer prices,** which are to apply from 1 July 2019, for standing offer customers on relevant tariffs; and,
- **A reference bill amount** for each network distribution region to make it easier for customers to compare offers.

The default market offer (DMO) price will affect residential and small business customers currently on flat rate standing offers in distribution zones where there is not already price regulation.

The DMO will limit the prices charged to standing offer customers, but not to customers on market offers.

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The AER's default price is intended to be a maximum price for standing offers for residential and small business customers, mitigating the impacts of high prices on disengaged customers, while allowing scope for continued competition in market offers.

The ESC's default price is intended to provide universal access to a 'fair price'.

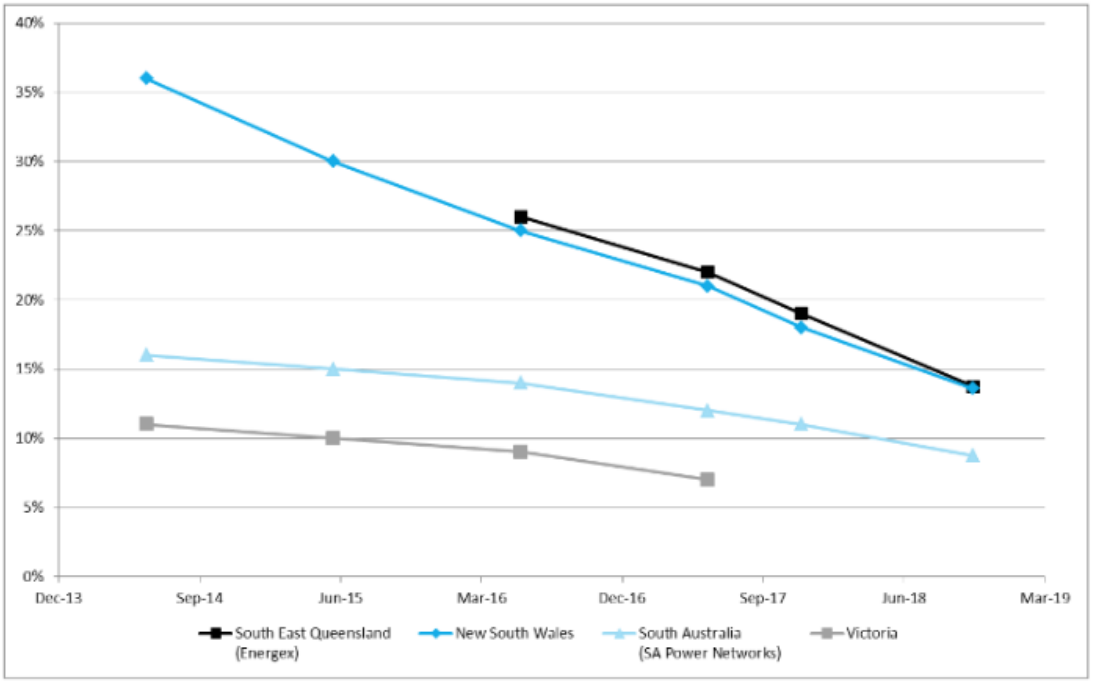
WHY A DEFAULT PRICE?

The Australian Competition and Consumer Commission (ACCC) stated that customers on standing offers were paying disproportionately more than market offer customers for electricity.

While the number of customers on standing offers is continuing to reduce (figure 1), there is still a proportion of customers who are not accessing more competitive market offers. Standing offers are currently set by electricity retailers who often discount against this price to make their market offers. Analysis by the Australian Energy Market Commission (AEMC) suggested this could be due to:

- (A lack of) customer awareness of the different types of offers available to them and the ability to switch providers;
- Whether customers actively investigate offers, and how they behave once they have investigated offers; and,
- The ability of customers to compare offers given the information that is available to them through private and government websites. Importantly, the AEMC also highlighted that reasons for not switching may differ between customers and classes of customers.

Figure 1: Percentage of residential customers on standing offers



Source: AEMC Final report Customer and competition impacts of a default offer – Final Report. ACCC Retail Electricity Pricing Inquiry - Final Report, Figure 12.4 for data points from June 2014 to December 2017. AEMC analysis of data provided by retailers for data on November 2018.

Note: The data point for November 2018 has been normalised to account for the 8 per cent of customers not captured in the data provided by retailers to the AEMC. Victorian customer numbers by offer type is released annually by the ESC and therefore is only available until June 2017.

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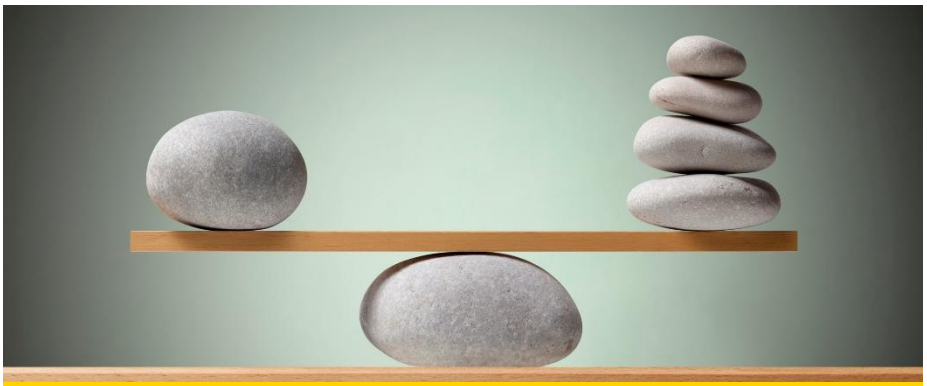
Will it work?

In a complex market, careful planning is required so the majority of customers will benefit from a reform and vulnerable customers are protected.

The DMO and VDO, if implemented, could increase the risks – and electricity costs – for the vast majority of customers who are currently actively engaged in the market and on better market deals.

The risks of the VDO, as highlighted in a recent report by Craig Emerson Economics, are vastly higher than those of the DMO. This is due to the different objectives of the reform.

There cannot be both a low-priced default price and a highly competitive market. Instead, through the implementation of a regulated price, consumers will likely see decreases in innovation and customer experience, and ultimately higher energy prices.



FINDING A BALANCE

Regulating prices for energy is a difficult task. Price regulation for an upcoming year will require a regulator to forecast costs that are not yet been incurred. Given these costs cannot be known at the time of the determination, regulators are required to identify appropriate upper and lower price thresholds. From within those thresholds, a regulator must then decide where the price should be set. In effect, this also determines who bears the risk:

- **Setting the price in the lower range** reduces the price for current standing offer customers but passes this risk onto retailers, and ultimately customers who have found a cheaper deal.

- **Setting the price in the higher range** means standing offer customers would pay slightly more but it may result in a better deal for other customers, as the risks for retailers are lower.

The price will change year on year depending on the input costs, and often is vastly dependent on the discretion of the determining regulator. This lack of predictability will constrain the ability of retailers to make long-term investments in the market, which will be to the detriment of energy consumers. The Grattan Institute highlighted this point in their submission to the AER's DMO Draft Decision:

"There is no 'right answer' to setting the DMO. But in our view the balance of risks supports erring on the side of a higher rather than a lower DMO. Customers are currently moving off high standing offers to lower market offers, and so the risks of setting a DMO that is too high are, in practice, modest. The same is not true of setting the DMO too low. Setting prices at or below the true cost of supply will substantially damage competition. This damage, once done, takes a long time to fix[2]."

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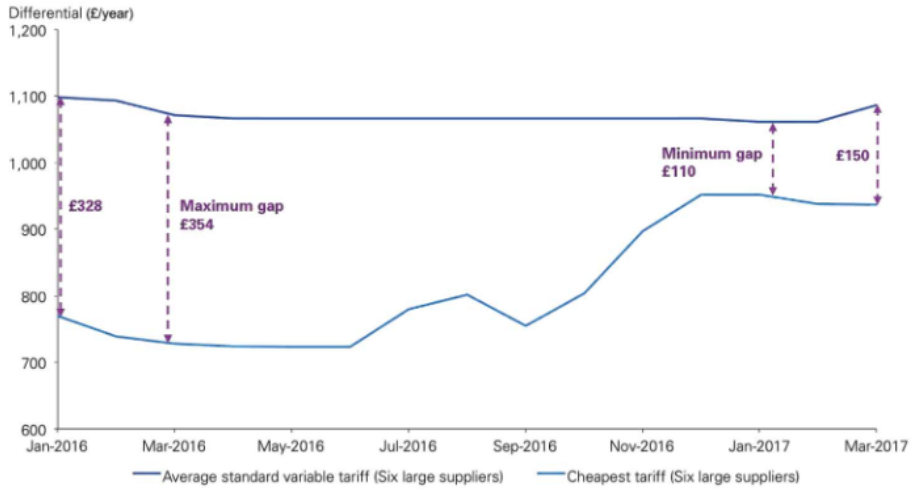
WHAT MIGHT OCCUR AFTER THE DEFAULT OFFERS ARE INTRODUCED?

In its advice to the COAG Energy Council in December 2018, the AEMC provided clear evidence of how prices narrow in regulated markets, citing recent UK experience where a temporary default offer cap was re-introduced. Figure 2 shows KPMG's analysis of the reaction of the largest six retailers in the UK to the cap with gap between the set price and market prices reducing. In other words, active customers are have seen their discounts fall.

Figure 2: Analysis of changes in retail prices in the UK



Source: KPMG, *What would a price cap mean for the UK?*, June 2018, KPMG, London, p. 5.
Note: KPMG analysis based on Ofgem's retailer price comparison data, 2017.

The AEMC also suggested that consumers would become less engaged in the market or perceive a regulated price as a safer choice than retailer's tariffs even where they would be worse off. Other risks include:

- **Withdrawal of the most competitively priced market offers:** This was a key conclusion of the AEMC's analysis of the DMO[3], and is a well understood outcome of imposing price regulation on a competitive market. While the AER wants to avoid disrupting retail competition, the AEMC concluded that the narrowing of prices through the withdrawal of the most competitive offers is a predictable and highly likely consequence of retail price regulation. This is because the introduction of retail price regulation creates considerable uncertainty about retailers' ability to recover their costs of doing business over the medium to longer term.
- **Reductions in current levels of service**: Retailers will reconsider elements of the service levels they have developed in the competitive market to win customers and differentiate themselves from other retailers. They may withdraw some of the key aspects of their offerings or impose charges for services that were previously offered without charge.
- **Reduced innovation over time:** Price regulation could undermine retailers' incentives to invest in their operations, simply because they may not be able to recover those costs or capture the benefits.
- **Managing price volatility:** Of particular concern is the ongoing volatility of wholesale electricity costs in the National Electricity Market (NEM). Given this volatility, it is critical that the AER (and the Essential Services Commission in Victoria) closely monitor input costs to ensure that default offers remain set at a price that allows retailers to recover their costs. This is particularly important for small energy retailers because they are often at the forefront of price and innovation, and regulators need to be cautious to ensure their ongoing sustainability is not put at risk as a result of this market intervention.

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More Information

Reports

KPMG: Evaluation of ESC draft advice on the Victorian Default Offer (April 2019)

Craig Emerson Economics: Economic consequences of the Victorian Default Offer (April 2019)

Oakley Greenwood: Benefits of a reference bill as compared to a default tariff (December 2018)

Australian Energy Council Submissions

Victorian Default Offer to apply from 1 July 2019: Draft Advice (4 April)

Draft Determination: Default Market Offer Price (20 March 2019)

[1] AER Position Paper Default Market Offer Price November 2018
[2] Grattan Institute, Default market offer draft determination: a pragmatic approach to a delicate balancing act
[3] AEMC, Customer and competition impacts of a default offer, Final report, 20 December 2018

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