Oakley Greenwood

Advantages of a Reference Bill as Compared to a Default Market Offer

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DISCLAIMER

This report was prepared at the request of the Australian Energy Council (AEC) to provide an independent assessment of the advantages and disadvantages of a Reference Bill as compared to a Default Market Offer, both of which were recommended by the Australian Competition and Consumer Commission (ACCC) as means for improving the competitiveness of the retail electricity market and improving the affordability of electricity for consumers.

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Executive Summary

On the 23rd of October, the Treasurer and Minister for Energy formally asked the AER to commence work immediately on developing a mechanism for determining the price of a default electricity market offer, consistent with the recommendations the ACCC made in its *Retail Electricity Pricing Inquiry – Final Report*. As part of this, the AER was also asked to develop a mechanism for determining a reference bill amount for each network distribution zone, from which headline discounts can be calculated.

A default market offer (or default tariff) is a regulated tariff that would be based on the regulator's assessment of the costs an efficient retailer would incur in providing electricity to customers. All retailers would be required to make that offer available to their customers, with all customers currently on standing offers automatically moving to this default tariff. Multiple default tariffs may need to be calculated (and hence offered by Retailers) to reflect factors that affect the costs of supply, such as the location of the customer (e.g., distribution region) and the type of customer (e.g., residential versus small business).

A reference price is a bill, against which all discounts can be measured. A reference bill would in effect reflect the combination of a reference price with an assumed electricity load. Where a reference bill is based on anything other than a very simple, flat-rate tariff structure, the electricity load assumptions would also need to consider the profile of energy consumption, not just the overall amount of energy consumed.

Whilst the two solutions may sound similar, the decision to implement a reference bill as compared to a default market offer, or both concurrently, predominantly comes down to whether or not policymakers' focus is to:

- 'Hard-wire' short-term reductions in prices for a small number of customers who are currently on standing offer charges ('default market offer'); or
- Facilitate a more efficient market in the longer-term to the benefit of ALL customers ('reference price').

Importantly, the ACCC did not suggest or recommend that competition in the retail electricity market should be abandoned. Rather, their focus was on how the competitive market could be made to work in the best interests of consumers.

This report was commissioned by the Australian Energy Council (AEC) to provide an independent assessment of the advantages and disadvantages of the two measures, and their simultaneous implementation.

Assessment of the ACCC's recommendations

The ACCC's recommendation of a default market offer is focussed on reducing the bills of customers that are still on a standing offer. The accompanying recommendation of the use of a reference bill is focussed on providing increased transparency, making it easier for all customers to compare market offers and thereby actively engage in and benefit from the competitive market.

Effect on customers on standing offers

Although implementation of a default market offer would provide an immediate benefit to customers currently on standing offers:

- The benefit provided by the default market offer is very likely to be materially less than what could reasonably be expected to occur in any case.

The percentage of customers on standing offers has been seen to decrease in all jurisdictions over time. According to figures presented by the ACCC, as at June 2017, these customers constituted no more than about 22% of customers in any NEM jurisdiction. Interestingly, customers on hardship and payment plan customers were found to be less likely to be on standing offers than other customers: in no jurisdiction were more than 13% of these customers on a standing offer, and in Victoria and South Australia only 4% and 5% of these customers were found to be on a standing offer.

The ACCC calculated the benefit that the implementation of the default market offer would provide by assuming it would be set halfway between current standing offer levels and current market offer levels. This level for the default market offer would deliver savings of about $610 million (NPV) to these customers over a five-year period.

However, the ACCC's analysis ignores the fact that, based on past experience, customers tend to move off standing offers over time. These customers get the full benefit of moving from the standing offer to a market offer. A calculation that assumes that this historical trend of switching away from standing offers continues (resulting in all jurisdictions reaching the level of standing offer customers just below that observed today in Victoria and South Australia) and that the customers who do switch obtain the full savings available from a market offer results in these savings totalling about $658 million over five years – about $48 million more than would be expected from the implementation of the default market offer.

In order for the benefits of the default market offer to break even with continued reliance on the historical trend for customers to switch away from standing offers, about 15% of the customers that could be expected to switch due to these historical trends would need to choose to switch to a market offer after having been automatically switched to the default market offer. As discussed below, it is not clear that this level of engagement would happen.

- The default market offer is unlikely to increase the engagement of these customers in the competitive market.

  Although under the ACCC's recommendation there would also be a reference bill available in the market, it is not clear that it would encourage additional engagement in the competitive market by existing standing offer customers. These customers have shown a propensity to not switch retailers, and the automatic transfer to the 'regulator-approved' default market offer will have delivered a material savings to them. This is unlikely to encourage them to engage with the market – and will have taught them nothing about how to do so. In addition, the availability of the default market offer will have reduced the potential benefit of any further switch to a market offer, and these customers may view any such a move away from the regulator-approved offer, particularly as it is likely to include customer protection features not available in all market offers.

Effects on the overall competitive market

The default market offer is also likely to pose risks for the overall market.

- Setting the level of the default market offer at the 'correct' level is extremely difficult.

  Setting the level of the default market offer requires the regulator to have a view about what level of costs a retailer will incur in serving customers, and what costs should be included in this allowance. Questions arise regarding whether costs above and beyond serving the customer – for example, the cost of acquiring and retaining customers – should be included. Similarly, there is the consideration of whether 'headroom' – a level of margin above costs – should be added to incentivise new retail businesses to enter the market.

Because the customer base of the incumbent retailers is much larger than that of a smaller recent entrant or a new entrant retailer, their economies of scale differ markedly, delivering a significantly lower level of cost to the larger retailers on a per-customer basis. Where the default market offer includes a lower cost to serve, it will disadvantage smaller retailers. At the margin, it can discourage market entry or even prompt market exit. Given the fact that new entrant retailers are often the engines of innovation in the market – due either to their introducing new pricing, product or service offerings, or simply the threat they pose to the existing retailers – this would likely be detrimental to the competitive market. By contrast; while a higher allowance for the cost to serve will make market entry and growth easier for new retailers, it will deliver margins in excess of the cost to serve to larger retailers from their customers that remain on the default market offer.

It is also the case that setting the default market offer will also add administrative costs to the market, as well as the time required for the annual process. There is also the potential for changes in the approach to setting the default market offer to create uncertainty in the market which could discourage retailers from making longer-term investments on the supply side, such as a smaller retailer entering into a long-term PPA with a large-scale wind farm in order to provide environmentally friendly retail products to the market.

- More importantly, the regulated default market offer is quite likely to reduce competition and innovation in the longer term, and result in the deals available in the market being less good than they otherwise would have been.

  The impact of a regulated price on the market was succinctly stated by IPART in its draft *Review of the performance and competitiveness of the retail energy market in NSW, From July 1 2017 to 30 June 2018* :(page 9).

  Re-introducing price regulation or a 'default tariff' is likely to lead to lower levels of competition and higher prices.

  In the short term a default tariff could help disengaged customers from paying excessive prices. However, over time it is likely to result in less customers actively shopping around in the market as the benefits from switching fall. In turn, this smaller market for 'active' customers would lead to less vigorous competition and innovation, with fewer retailers competing in this market

An alternative approach

The introduction of a reference bill on its own would seem to offer a better approach for achieving the ACCC's objectives of putting downward pressure on customers' bills, and doing so in a manner that mitigates the potential damage that re-regulating retail prices could impose on the competitive market.

More specifically, the introduction of a reference bill (without an associated default market offer) would have the following advantages:

- It focuses on a critical issue currently affecting the efficacy of the broader market – that being the confusing nature of discounts.
- It would also enhance the effectiveness of the retail electricity market in a number of ways.
  - Most basically, by making offers easier to compare, a reference bill would sharpen competition. It would provide consumers with much easier access to relevant information about the electricity offers that are available in the market, and thereby minimise information asymmetries – both of which are key conditions of an effective competitive market that are not currently being met.

- It would enhance the value of discounts as a means of alerting customers to better deals. By doing so, it would (a) allow the use of discounts to be a valuable source of information – rather than confusion – for consumers, and (b) be likely to increase consumer confidence in the market, as consumers would actually know what the published discount means and be assured that it provides a meaningful comparison of competing offers.

- It is easier and less costly to implement.

  A reference bill serves as a benchmark. As such, it does not need to be exactly accurate – it only needs to be a consistent figure against which comparisons are made. This will make calculating it easier and less costly for the AER without sacrificing any of its information value in the market.

- It entails less risk of imposing unintended consequences on the market. Examples of such unintended consequences include:

  - A reference bill – particularly as compared to a default market offer – would not add to the Status Quo bias – the fact that people tend to prefer familiarity and predictable outcomes over unproven new alternatives – that has been noted by several commentators as a factor in why consumers fail to engage with the market.

  - A reference bill introduced on its own would impose less (uncontrollable) risk on retailers, as they would not be required to offer the reference bill (or any particular set of prices on which it is based) to end customers. Rather, the retailer would simply need to provide a comparison of the representative outturn bill of the offer (given a specified level of consumption) to the reference bill.

  - Although a default market offer would provide consumers on standing offers with an immediate reduction in their bills (and a potential but smaller bill reduction for customers on market offers above the default market offer), that benefit will be smaller than what would be expected to occur in any case, or with the introduction of a reference bill. This is because the introduction of a default market offer will be likely to (a) reinforce consumers' Status Quo bias and (b) reduce the competitiveness of new entrant retailers whose presence generally provides additional innovation and downward pressure on prices.

- Even more importantly, a reference bill – in combination with other tools such as the comparison websites – can help create the type of well-functioning competitive market that is needed to achieve the ACCC's objectives – one that is easy for consumers to engage with and thereby encourages competition in pricing and innovation in product and service offerings.

- It provides a step-wise approach to addressing the problems that have been observed in the market. By contrast, implementing a reference bill at the same time and that is linked to a default market offer would:

  - entail more time and costs to implement,

  - impose risks to the competitive market;

  - make it very difficult to determine whether the reference bill on its own would have provided sufficient remediation; and

  - make it more difficult to move away from regulated prices in favour of a fully competitive market at some point in the future.

1. Background

Retail electricity prices essentially doubled in the decade from 2006 to 2017. In March 2017, the Commonwealth government asked the Australian Competition and Consumer Commission (ACCC) to assess the costs, margins and business practices of the electricity sector to determine the drivers of these increases and how downward pressure could be put on consumers' prices. The ACCC's final report, *Restoring electricity affordability and Australia's competitive advantage*, which was published in June 2018, concluded that, while different parts of the supply chain have contributed to price increases at different times over that period, most recently:

- Costs and margins in the retail electricity sector had grown substantially, contributing materially to increased prices; and
- The heavy reliance on discounts as the primary means for presenting competitive market offers lacked transparency and made informed decisions by consumers difficult, particularly in jurisdictions where electricity pricing had been fully de-regulated.

The ACCC study offered more than 50 specific recommendations. In the retail electricity sector, the two most significant were that:

- The standing offer and standard retail contract used in jurisdictions in which retail electricity prices have been fully de-regulated should be abolished and replaced with a default market offer (a default tariff) at or below a price which would be set by the Australian Energy Regulator (AER) (Recommendation 30); and
- If a retailer chooses to use discounts to advertise its market offers these discounts must be unconditional and must be calculated based on a reference bill amount that would be calculated and published by the AER using the default market offer and 'typical' consumption levels of different sized households (Recommendation 32).

Importantly, the ACCC did not suggest or recommend that competition in the retail electricity market should be abandoned. Rather, their focus was on how the competitive market could be made to work in the best interests of consumers. As they stated[1]:

> *the ACCC is confident that there is much that can be done to boost competition, lower costs and improve consumer experiences in the electricity market. In doing so, we can 'reset' the NEM to return Australia's competitive advantage in electricity and restore consumer confidence.*

2. Objective and organisation of this Report

The Australian Energy Council (AEC) has engaged Oakley Greenwood (OGW) to provide an independent assessment of the advantages and disadvantages in both the near and longer term of two of the approaches that have been put forward to address these issues. Those two approaches are:

- A default market offer, which is a market retail electricity offer that would be set by the AER for each distribution area and that all retailers operating in that area would be required to offer, and

1 ACCC, *Restoring electricity affordability and Australia's competitive advantages: Retail Electricity Pricing Inquiry – Final Report*, June 2018, p xvi.

- A reference bill, which is a bill that all discounts being made in the market must be compared to, but which is not based on a price that is required to be available in the market.

The remaining sections of this report:

- Discuss the features that a workably competitive retail electricity market would be expected to exhibit (Section 3);
- Summarise the key problems that have been identified in the retail electricity market at present (Section 4);
- Discuss the ACCC's commentary on these problems and its proposed solution to them (Section 5);
- Review the features of the two primary recommendations put forward by the ACCC for addressing the problems in the retail portion of the electricity market (Section 6);
- Discuss the conceptual advantages and disadvantages of a default market offer and reference bill and their potential economic and financial impacts (Sections 7 and 8); and
- Provide initial thoughts on how a reference bill could be calculated and implemented in practice (Section 9).

3. The key features of a workably competitive retail electricity market

A workably competitive retail electricity market should exhibit a number of key features, including, but not limited to:

- It should incentivise service providers to innovate by providing a range of products and services that customers express a willingness to pay for;
- It should place downward pressure on overall costs and therefore prices, as retailers seek to retain or gain market share by helping customers reduce their electricity costs;
- It should lead to retail electricity prices that maximise economic welfare (producer and consumer surplus);
- It should minimise the transaction costs incurred by buyers and sellers interacting with the market; and
- It should provide easy access to relevant information and minimise information asymmetries.

A key issue that has been raised in the context of the retail electricity market is the concept of price dispersion, and whether price dispersion – that is, similar services being offered at different prices - is consistent with retail electricity prices that maximise economic welfare (producer and consumer surplus). Put simply – should we expect some price dispersion in a workably competitive electricity market?

As the ACCC notes in its report, "*economic literature generally considers price dispersion to be a normal and efficient outcome from competitive markets*" (page 259). The ACCC notes more generally that "*it is expected that a competitive market will result in 'sticky' customers paying more than consumers who regularly switch*" (page 249).

However, the caveat to this is that transaction costs must be kept to a minimum, and the market should not be characterised as having asymmetric information. To our mind, these are areas in which the retail electricity market in the NEM is deficient and that need remedial attention. The ACCC noted similar concerns in its report[2]:

> *the ACCC is concerned that price dispersion in the NEM is less a result of efficient price discrimination and more a function of retailers taking advantage of:*
>
> - *consumer confusion due to pricing and discounting practices of retailers*
> - *some consumers being unaware that they will likely be paying more by not actively shopping around and switching (a kind of 'loyalty tax')*
> - *some consumers facing barriers to engagement in the market.*

The retailers themselves have admitted that this is a feature of the market that could be improved[3]:

A final feature of competitive markets is that they are generally not the best vehicle for addressing social policy objectives. Rather, these objectives are best addressed through direct government action, including the use of the tax/transfer system (e.g., pensions, welfare arrangements, concession arrangements) and targeted programs, as these will have the least distortionary impact on the supply of and demand for the underlying product or service.

4. Summary of the key perceived problems with the existing retail electricity market

Following on from the above, the current retail electricity market is perceived by some as having a number of underlying problems, including, but not limited to:

- The market, and in particular the marketing of discounts, being confusing at best, and in some cases, misleading. This confusion impacts on the efficient operation of the market;
- Loyal customers being 'penalised' by their retailers through, in particular, the imposition of high standing offer charges; and
- Vulnerable consumers not being adequately protected.

5. The ACCC's commentary on these problems and its proposed solution

The ACCC reported on a significant amount of analysis and made more than 50 recommendations in its Final Report. In relation to the perceived problems mentioned above, the most relevant ones are as follows:

- **A default market offer be introduced:** In non-price regulated jurisdictions, the ACCC has recommended that standing offers and standard retail contracts should be abolished and replaced with a default market offer at or below the price set by the AER. They indicate that this default market offer should:

2 ACCC, op. cit., p 259.

3 Angela Macdonald-Smith, *Australian Financial Review*, "Look elsewhere for price cuts: Retailers", 02 November 2018, p 9.

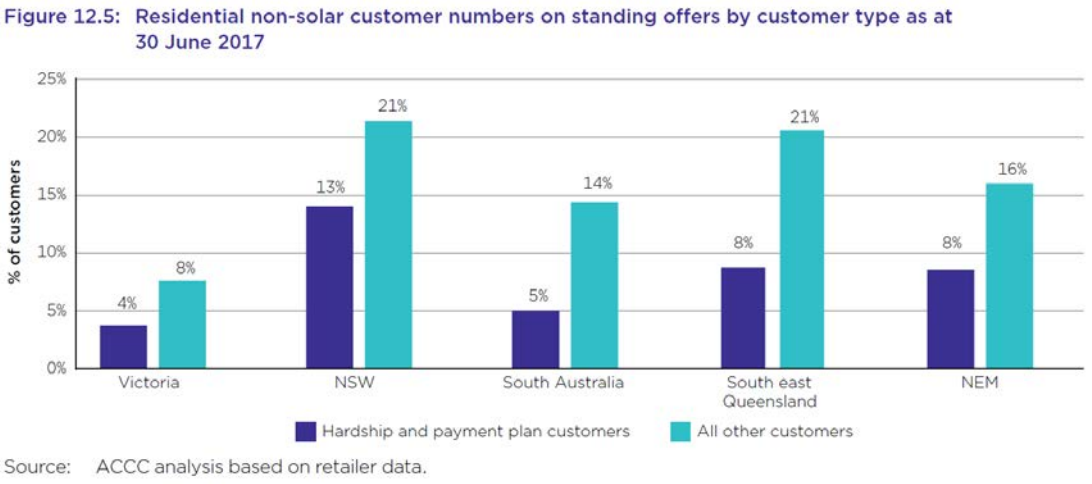
- reflect the efficient cost of operating in the region, including a reasonable margin as well as customer acquisition and retention costs; and
- be used by retailers in all circumstances where a standing offer is currently used, including circumstances where a consumer has moved into a premise but has not contacted the retailer, where a consumer has not selected a market offer before the expiry of a market contract, and where a consumer is switched through a retailer of last resort event.

- **A reference bill be introduced:** The ACCC indicates that if a retailer chooses to advertise using a headline discount claim, it must calculate the discount from the reference bill amount published by the AER. The reference bill amount calculated by the AER should be for each distribution area using the default market offer within that area and AER consumption benchmarks for medium-sized (2-3 person) households.

On the 23rd of October, the Treasurer and the Minister for Energy formally asked the AER to immediately commence work on developing a mechanism for determining the price of the default market offer, consistent with the ACCC's recommendations. As part of this, the AER was also asked to develop a mechanism for determining a reference bill amount for each network distribution zone, from which headline discounts can be calculated.

In relation to the third perceived problem – the protection of vulnerable customers - the ACCC's analysis of retailers' data suggests that customers on payment plans and hardship schemes are less likely to be on (higher) standing offers than other consumers (see Figure 1 below). They surmise that this may be due to consumers on hardship and payment plans having a greater incentive to find better priced market offers, and/or that retailers who engage with consumers to place them on hardship and payment plans also take steps to help these consumers move to market offers, though they also note that hardship "*is only one indicator of vulnerability, and there are potentially many vulnerable consumers that are not on payment plans or in retailer hardship schemes*"[4].

Figure 1: ACCC's analysis of hardship and payment plan customers on standing offers



Source: ACCC analysis based on retailer data.

4 ACCC, op. cit., p 244.

In any case, on face value, the market would appear to be leading to outcomes that are generally aligned with Government's broader social policy objective regarding vulnerable customers. Further, explicit, support is provided to most long-term vulnerable customers through the electricity concession arrangements that are in place within the tax/transfer system, as well as specific assistance programs provided by the Government and the industry.

6. The difference between a default market offer and a reference bill

A default market offer is a market offer that would be set by the AER based on its assessment of the costs an efficient retailer would incur in providing electricity to customers. All retailers would be required to make that offer available to their customers within a particular area. Multiple default market offers will likely need to be calculated (and hence offered by retailers) to reflect factors that affect the costs of supply, such as the location of the customer (e.g., distribution region) and the type of customer (e.g., residential versus small business).

Whilst the ACCC's underlying objective for a default market offer is for it to take the place of the existing standing offer tariff, it is our understanding that it would also be available to customers who are currently on market offers. Presumably, the extent to which a customer may be willing to switch from a market offer to the default market offer will depend on the relative price of the two offers, and differences in their terms and conditions, and any perceptions the customer may have regarding the protections that are provided by the "regulator-approved" status of the default market offer, as compared to the market offer they are currently on.

A reference bill would be developed by the AER and would be a bill against which all discounts could be measured. A reference bill would in effect reflect the combination of a price with an assumed electricity load. Where a reference bill is based on anything other than a very simple, flat-rate tariff structure[5], the electricity load assumptions would also need to consider the profile of energy consumption, not just the overall amount of energy consumed.

7. Conceptual advantages and disadvantages of the two approaches

7.1. Advantages of a default market offer

The advantages of a default market offer primarily stem from the regulatory protections that it provides. These regulatory protections are generally required to support the achievement of efficient outcomes in markets where:

- there is no retail competition (in order to avoid monopolistic price-setting), or
- where there is some retail competition, yet despite this, significant 'market power' issues are still prevalent in the market[6].

However, in many Australian retail electricity markets[7]:

5 Essentially, a tariff structure with a fixed daily or monthly charge and a single rate for all electricity consumption regardless of volume or time. Other tariff structures that would require information about the profile of consumption include time-of-use, off-peak, and controlled load tariffs, as well as tariffs with a demand component.

6 An example of this would be if a region had only a small number of active retailers, and none of the available market offers reflected the efficient costs of providing electricity services to customers in that region.

7 When considering market power related concepts, the NEM is not one single market. For example, each State has different levels of retail competition.

- there is retail competition, and
- that competition has facilitated a significant number of retailers competing for customers in those markets, leading to many offers that would likely be considered to be efficient in any assessment.

Notwithstanding this, the ACCC has proposed the broader introduction of a default market offer into the NEM. Its rationale is that it[8]:

> *considers that a direct price intervention is required to counter retailers' incentives to inflate standing offer prices and take advantage of consumers who are not engaged.*

In this context, the ACCC appears to view the default market offer as having the advantage of better protecting a certain subset of electricity customers – namely those that have *not* already engaged in the electricity market – as compared to a situation where the outcomes for those customers are left to the market. In effect, it allows this sub-set of customers to avoid having to incur transaction costs to achieve a market offer outcome that is more 'reasonable' than the standing offer they are currently on.

7.2. Disadvantages of a default market offer

The potential disadvantages of a default market offer depend in part on what:

- cost categories the regulator is required to incorporate (or not incorporate as the case may be) into its calculation, and
- the level those costs are set at.

The following three sub-sections highlight the impact of these decisions in more detail using three different approaches to setting a default market offer.

7.2.1. A 'Basic Service Offer'

One approach is to introduce what some have referred to as a Basic Service Offer (BSO). A BSO, involves basing the default market offer on the efficient retail costs-to-serve, excluding customer acquisition and retention (CARC) costs. A BSO was recommended by the Thwaites Review in Victoria[9].

By excluding CARC, proponents of such an approach to regulating electricity prices would appear to be implicitly suggesting that:

- There are no longer-term, dynamic efficiency benefits stemming from facilitating retail competition (i.e., retail competition does not in fact lead to outcomes that are to the benefit of consumers in the long term), hence the costs associated with 'competition' should be excluded from the derivation of a regulated default market offer; or

8 ACCC, *Restoring electricity affordability and Australia's competitive advantages: Retail Electricity Pricing Inquiry – Final Report*, June 2018, p 249.

9 *Independent review into the electricity and gas retail markets in Victoria*, August 2017

- The retail electricity price is the only information that customers require to make an informed electricity procurement decision in the short and long term, *and* that customers and businesses face no transaction costs related to this price discovery process (i.e., the prices offered by all retailers will be available to all consumers whenever they are making a retail electricity contract decision and the market will operate efficiently based solely on the universal availability of all price offers, hence there is no need for any other information provision such as marketing or communications).

The risk is that if either of the above assumptions does not hold true, the introduction of a BSO-type default tariff diminishes competition in the long run which, as we discuss below, will be detrimental to all customers.

To this end, it is a reasonably widespread held view that smaller retailers have tended to be the ones that have provided some of the lowest cost offers in the market[10], and that they have also tended to be some of the most innovative service providers[11]. Moreover, evidence would suggest that even the *threat* of competition can lead larger incumbent retailers to reduce their margins on and prices to customers. The NSW gas market provides a good example of how the existence of smaller retailers in a market may impact on price outcomes. In a study conducted for IPART, a comparison was undertaken of the retail operating costs that could be inferred from the (approximately) bottom third of the market offers available in Sydney on the one hand and Albury and Queanbeyan on the other[12].

- In the Sydney market - which is characterised by a robust level of competition – retail operating costs appear to be only about $82.50 per customer in 2018/19, which is significantly below previously published benchmarks; *whereas*
- In the Albury and Queanbeyan markets – in which only Tier 1 retailers (and ActewAGL in Queanbeyan) provide retail electricity services – per customer retail operating costs appear to be about $243 (in Albury) and $445 (in Queanbeyan) in 2018/19, which is significantly above previously published benchmarks[13].

10 For example, using data from the ESC's 2016/17 Victorian Energy Market Report – Appendix – Electricity retail products and prices, we have estimated that 8 of the 10 lowest discounted residential market offers in the Eastern Victorian region are from Tier 2 retailers (page 192); 9 out of the 10 lowest discounted offers in the Western region are from Tier 2 retailers (page 196); 8 out of the 10 lowest offers in the CBD/Inner suburbs are from Tier 2 retailers (page 200); 8 out of the 10 lowest offers in the South Eastern and Mornington Peninsula region are from Tier 2 retailers (page 204); and 8 out of the 10 lowest offers in the North Western part of Melbourne are from Tier 2 retailers (page 208).

11 For example, Powershop offers Powerpacks which give consumers much more flexibility in how they purchase electricity as compared to the standard market offers. Their 'Curb Your Power' program (part of an ARENA-funded three-year trial of the use of demand response in the RERT) leverages the AMI roll-out in Victoria to provide consumers with a way to earn bill credits while contributing to system reliability.

12 OGW, *Efficiency of Gas Prices Efficiency of Gas Prices Efficiency of Gas Prices Efficiency of Gas Prices for Small Customers in for Small Customers in for Small Customers in for Small Customers in NSW,* Appendix A.

13 Whilst some of this difference may in part reflect the level of scale achievable in the different markets, which in turn would impact on the cost of recruitment and retention per customer, it is difficult, on face value, to see that this would explain entirely the sizable difference in the retail operating costs inferred from the available market offers.

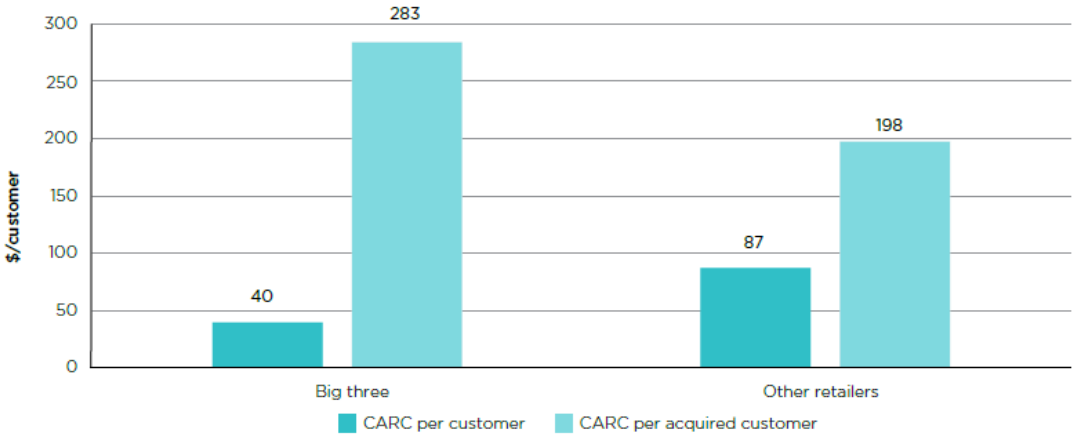
Following on from this, the question then becomes whether retail competition could (continue to) develop purely as a result of publishing the electricity prices offered by the different retailers, without any further effort (and related marketing and advertising expenditure) to make existing and prospective customers aware of those prices (and potentially the other benefits or advantages of signing up with one retailer as compared to another). The available evidence would not seem to support this, as discussed below.

In particular, previous research[14] into retail electricity markets has indicated that a large barrier to switching retailers is what is called Status Quo bias. This issue is described as follows[15]:

> *Much of people's behaviour is habitual, and people typically prefer doing as they have always done. As a result, people often retain default options rather than instigating change. This effect occurs even in instances where the alternative choices are 'rationally' preferable, because people prefer familiarity and predictable outcomes over unproven new alternatives*

This barrier to switching – and hence competition – needs to be overcome by means other than simply "having the cheapest price". It requires communication and marketing to ensure that customers are aware of and comfortable with a retailer's product and service offering – beyond simply its price. This may explain why it is not just large retailers who spend money on CARC, with smaller retailers also spending significantly on CARC. In fact, figures in the ACCC report indicate that smaller retailers spend $87 per customer on CARC, as compared to $40 per customer for Tier 1 retailers[16].

Figure 2: NEM-wide CARC, 2016-17, $ per residential customer and per acquired customer, excluding GST



Source: ACCC report, p 230.

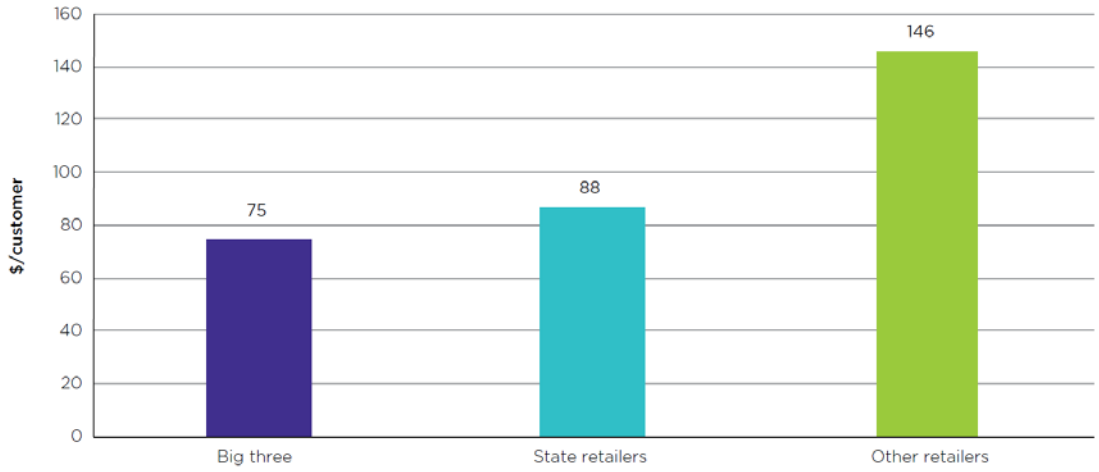
Finally, it is important to note that smaller retailers' underlying costs-to-serve are higher than larger retailers, simply due to a lack of economies of scale, which means that smaller retailers must continue to attract and retain new customers to obtain scale in order to compete with Tier 1 retailers in the long run. Quite simply, smaller retailers need effective retail competition to survive; larger retailers do not.

14 For example, this was a key issue identified by the CSIRO as affecting retail competition in Victoria.

15 CSIRO, *Exploring the drivers and barriers of consumer engagement in the Victorian retail energy market*, page 8.

16 It is our understanding from the ACCC report (see page 230) that despite the title, these dollar amounts shown in the figure do not include retention costs.

Figure 3: NEM-wide Costs to Serve by retailer tier, 2016-17, $ per residential customer



Source: ACCC report, page 224

Based on these factors, it is highly likely that the adoption of a BSO-style default tariff would regulate most smaller retailers out of existence, as:

- The default market offer would most likely reflect a Tier 1 retailer's costs, as Tier 1 retailers have lower costs-to-serve than other retailers due to their economies of scale, hence affecting the short-term commercial viability of smaller retailers;

whilst

- Also affecting the longer-term commercial viability of the smaller retailers, as it would almost certainly preclude a small retailer from adopting an approach that involves them accepting lower returns in the short-term in order to attract new customers and build their brand – in the face of Status Quo bias – and thereby achieve greater economies of scale and hence competitiveness in the longer-term.

Therefore, a focus on the short-run, efficient retail costs-to-serve, at the expense of dynamic efficiency in the longer run will almost certainly result in smaller retailers leaving the market and with them, the innovation and competitive tension they provide. The inevitable outcome of this is that the positions of the Tier 1 retailers would actually be strengthened, at the expense of customers.

This is aptly described by the ACCC in their report[17]:

> *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. ……. In addition, as a BSO does not include any CARC, it may lead to some retailers exiting the market, leading to fewer options for consumers. The ACCC notes that a similar outcome occurred in France when regulated tariffs were set at a level that other retailers were not able to supply at. The French Government has subsequently removed the price cap*

17 ACCC, *Restoring electricity affordability and Australia's competitive advantages: Retail Electricity Pricing Inquiry – Final Report*, June 2018, p 250.

7.2.2. Including CARC as well as an allowance for headroom

Another alternative is to not only include an allowance for retail costs-to-serve, but to also include an allowance for the efficient CARC costs as well as an allowance for headroom (i.e., an increment between the efficient level of costs and the level of the default tariff cap[18]).

This approach was adopted by a number of States, for example in Victoria, prior to deregulation, and in NSW during certain periods, particularly between 2010 - 2013. This approach has also been adopted by OFGEM in the UK in its recent decisions related to the setting and updating of a default tariff cap, although it appears that headroom is predominately incorporated to account for "uncertainty and variation in efficient costs", not to explicitly facilitate switching.

The advantage of this approach as compared to a BSO-type default tariff arrangement is that it is much less likely to crowd out competition in the retail market, whilst still providing some protection for customers who are not actively engaged in the retail electricity market (e.g., those currently on standing offers).

In its 2013 review of regulated retail prices, IPART, when commenting on the different incentives (e.g., levels of headroom) included in regulated prices, stated that[19]:

> *Our comparison of the incentive included in regulated prices with observed indicators of competitive market outcomes over these determination periods suggests there is a clear relationship between these incentives and the level of competition in the market.*

IPART followed on by noting that[20]:

> *In Queensland, lower incentives in regulated retail prices (relative to those in NSW and Victoria) have occurred alongside relatively lower levels of customer switching (which ranged between 10% to 15% over the past 12 months, compared to between 16% to 23% in NSW).*

The disadvantage of this approach is that if the allowance for headroom actually achieves what it is intended to achieve (i.e., facilitate competition, but provide some minimum protection for customers regarding price), it provides only a relatively small benefit to the relatively small number of customers who are currently on standing offers (although it still may "sound good" from a political perspective).

More importantly, this approach may also lead customers who initially benefit from moving to this slightly lower default offer, to be worse off in the long run, if it disincentivises them to actively engage in the market in the long run. This may occur due to their *perception* that they are on a "good" tariff (e.g., because it has been approved by an independent regulator, it *must* be in my best interests to continue on this tariff). This would be likely to strengthen the Status Quo bias issue that was described earlier.

Therefore, to the extent that a Regulator-approved default market offer disincentivises customers to actively engage in the market in the future, customers on that default market offer will be paying more than they otherwise could be paying. The impact of this outcome is outlined in more detail in Section 8.

18 OFGEM, *Default Tariff Cap: Statutory Consultation Appendix 2 - Cap level analysis and headroom,* page 5.

19 IPART, *Review of regulated retail prices and charges for electricity*, June 2013, page 113.

20 IPART, *Review of regulated retail prices and charges for electricity*, June 2013, page 114.

7.2.3. Efficient costs to serve plus an allowance for the efficient CARC costs

Sitting between a BSO-style default tariff and a default market offer that explicitly makes some allowance for headroom, is a default market offer that reflects a "point estimate" of the efficient costs to serve *plus* an allowance for the efficient CARC, but which *excludes* an allowance for headroom. This approach is the one that appears to most closely align with what the ACCC has recommended, and in turn, what the Government appears to have asked the AER to determine.

On face value, deriving a precise 'point estimate' of the efficient costs or providing retail services sounds appealing, as it would appear to:

- protect those customers who have not engaged in the market up until now, whilst
- having little impact on the broader competitive market.

However, the first and most obvious issue is that this task is administratively very complex, and there is a significant risk of the AER getting it wrong[21] (and this is not a criticism of the AER as any regulator or organisation would face a similar risk).

The energy market is categorised by a number of different discrete components (or parts of the value chain), each facing different pricing and forecasting risks. In particular, whilst network charges are set in advance for a year (hence there is some price certainty), volumes are not known for certain. No such price certainty applies to wholesale prices (and therefore costs), which are a function of a competitive market. Wholesale electricity prices – including the price of wholesale electricity futures contracts, which is the electricity 'product' that is most relevant to the forecasting of future electricity retail tariffs – can fluctuate significantly within a short space of time.

If the AER's assumptions around the timing and structure of retailers' contracting practice differs from what actually takes place in the market, the outturn default market offer will be wrong. This dramatically increases the risk of operating as a retailer, which in turn may incentivise retailers to either:

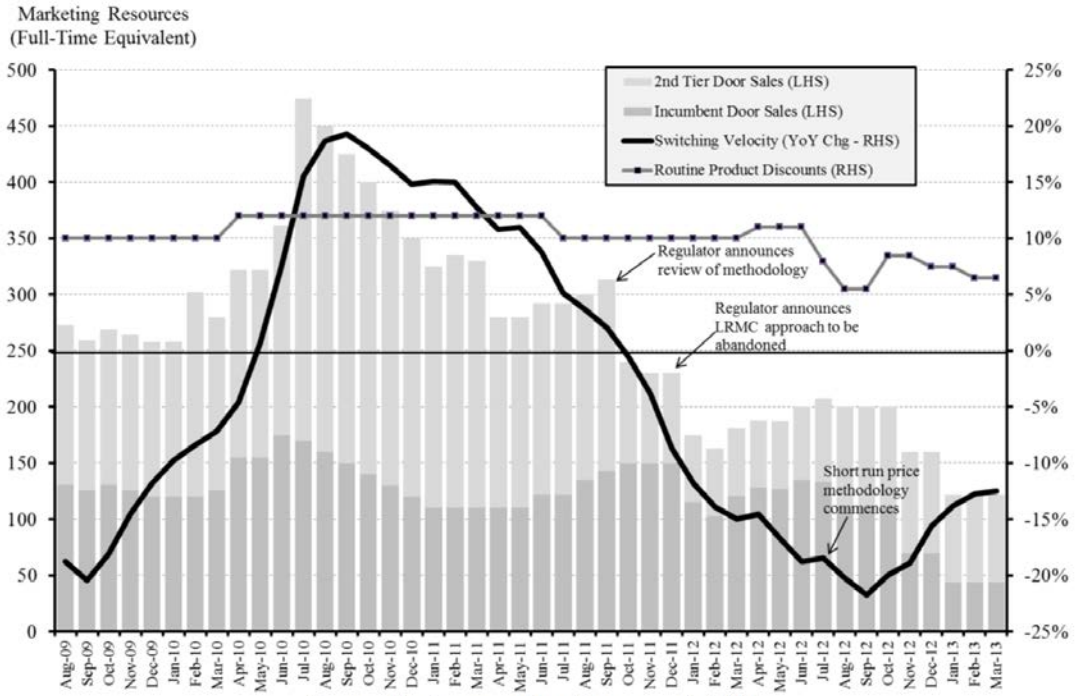
- align their contracting practices with the underlying methodology the AER uses to set the default market offer in the longer-term. This 'mimicking' of a regulator's approach is likely to have long-term negative implications for efficiency; or
- exit (or not enter) the market, if the risk is too great.

Moreover, if the rules underpinning the development of the default market offer are not explicitly prescribed and trusted by market participants, retailers will be loath to directly or indirectly make any long-term investments on the supply side, no matter what the initial default market offer outcomes are. For example, a smaller retailer that is considering entering into a long-term PPA with a large-scale wind farm in order to provide environmentally friendly retail products to its retail customers may be unwilling to enter into such an arrangement if they perceive that the retail pricing arrangements are uncertain or potentially subject to future government interference. This is of particular concern in an environment where the market requires new supply-side investments, and many of the new, smaller-scale generation projects are being underpinned by PPAs with smaller-scale retailers.

21 It should also be noted that this risk is very different to the risk of the AER getting its network price-setting process wrong, as the former can lead to businesses exiting the market and competition in the market being significantly affected, whereas in the case of the latter, there is virtually no risk of a business exiting the market, but there is a risk of transfers between customers and the distribution business, with transfers that overly reduce revenue to the distributor posing a risk to quality of service.

A paper by Paul Simshauser[22] presents evidence showing some of the impact that resulted from a change in the way regulated retail prices were set in Queensland. In particular, the paper presents data on industry marketing resources, routine product discounts, and the resulting change in customer 'switching velocity'[23] in the period before and after the announced change in the price-setting methodology.

Figure 4: Marketing Resources, Switching Velocity and Routine Discounts in Queensland[24]



Source: Simshauser and Laochumnanvanit (2012).

This information indicates that from late 2011 there was a sharp drop in the proportion of door-to-door sales on the part of 2nd tier retailers as compared to 1st tier retailers. Prima facie, this indicates a drop in competition, with the most pronounced effect being on the activity of 2nd tier retailers. This drop coincided with a review and change in the methodology used by the Queensland regulator in setting the regulated retail price of electricity. The author then states[25]:

> *Note that once the short run price methodology result is announced and implemented in mid-2012, price discounts drop and settle at 7%. Finally, Switching Velocity (black line trace measured on the RHS Axis) largely follows the price and product marketing results. Switching Velocity is a measure of the Year-on-Year change in the total number of customers who have switched - and any result above the origin means that market competition is accelerating, and results below the origin mean that market competition is contracting at varying levels of intensity.*

22 Currently Professor of Economics at Griffith University and Executive General Manager, Corporate Development, Infigen Energy. He is a former Director General of the Queensland Department of Energy and Water Supply, and at the time the paper was written, was Chief Economist at AGL Energy Ltd.

23 'Switching velocity' is defined in the paper as the year-on-year change in the number of customers switching retailer.

24 Paul Simshauser, *Three guiding principles for price cap regulation,* page 12.

25 Ibid.

More broadly, even absent any of the above issues, any approach to setting a default market offer is likely to have the same negative implications for retail competition as was described in earlier sections. In particular, it is likely to reinforce Status Quo bias, as some customers are likely to perceive a default market offer as being in their best interests. This reduces their incentive to actively engage in the market to seek out better deals – including looking for more innovative and cheaper price/service offerings - which, as discussed earlier, is exactly what smaller retailers require in order to effectively operate in the retail market in the longer-term.

The long-term consequences of all of this are likely to be a reduction in customer activity, a diminishment in retail competition and higher long-term prices. IPART provided a concise summary of this issue in its recent report[26], when its stated that:

> *We consider that a non-binding benchmark tariff could also assist customers to assess the value of different offers,* ***without reducing levels of customer engagement or creating additional risks for retailers.*** *On the other hand,* ***re-introducing price regulation or a 'default tariff' is likely to lead to lower levels of competition and higher prices*** *[Emphasis added].*
>
> *In the short term a default tariff could help disengaged customers from paying excessive prices. However, over time it is likely to result in less customers actively shopping around in the market as the benefits from switching fall. In turn, this smaller market for 'active' customers would lead to less vigorous competition and innovation, with fewer retailers competing in this market (Figure 1.3).*

7.3. Advantages of a reference bill introduced on its own

In comparison to the introduction of a default market offer and reference bill that is calculated from it, the introduction of a reference bill on its own would be likely to complement and improve the operation of the existing market better and at lower cost.

In particular, the introduction of a reference bill (without an associated default market offer) has the following advantages:

- It focuses on a critical issue currently affecting the efficacy of the broader market – that being the confusing nature of discounts.

  A reference bill (or reference price) would directly address one of the main concerns that the ACCC expressed regarding the price dispersion observed in the retail electricity market, namely, "*retailers taking advantage of consumer confusion due to pricing and discounting practices . . .*"[27].

- It would also enhance the effectiveness of the retail electricity market in a number of ways.
  - Most basically, by making offers easier to compare, a reference bill would sharpen competition.
  - It would provide consumers with much easier access to relevant information about the electricity offers that are available in the market, and thereby minimise information asymmetries – both of which are key conditions of an effective competitive market that are not currently being met.

26 IPART, *Review of the performance and competitiveness of the retail energy market in NSW, From July 1 2017 to 30 June 2018,* Draft Report, page 9.

27 ACCC, *Restoring electricity affordability and Australia's competitive advantages: Retail Electricity Pricing Inquiry – Final Report*, June 2018, p 259.

- It would enhance the value of discounts as a means of alerting customers to better deals. It would deliver a consistent and transparent base that consumers could use for comparing the prices and discounts contained in different market offers. By doing so, it would allow the use of discounts to be a valuable source of information – rather than confusion – for consumers. As the ACCC state in their report[28]:

  if used appropriately and taken from a consistent benchmark, a discount is a simple way to compare two offers and assess whether one is likely to lead to lower bills than the other.

- This would be likely to increase consumer confidence in the market, as consumers would actually know what the published discount means and be assured that it provides a meaningful comparison of competing offers. This increased confidence would make it more likely that consumers would actively engage in the market to seek out better deals.

- In addition, by providing an easy way to compare the estimated size of the bill that would result from different offers the reference bill would make it easier for consumers to compare the value of non-price (i.e., product and service) features of competing market offers. This is likely to be of increased importance as the availability and price competitiveness of alternative means for meeting consumers' needs for energy increases. As noted by the ACCC[29]:

  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.

- It is easier and less costly to implement.

  A reference bill serves as a benchmark. As such, it does not need to be exactly accurate – it only needs to be a consistent figure against which comparisons are made. This will make calculating it easier and less costly for the AER without sacrificing any of its information value in the market. Its power comes from the accuracy it provides as a means for comparing competing offers, not its accuracy concerning the actual costs and margins of any particular or theoretical retailer.

- It entails less risk of imposing unintended consequences on the market. Examples of such unintended consequences include:

  - Reinforcing the Status Quo bias.

    A reference bill – particularly as compared to a default market offer – would not add to the Status Quo bias that has been noted by several commentators as a factor in why consumers fail to engage with the market. To the contrary, it is possible that, by making information with which to compare competing market offers easier to understand and more reliable, the reference bill could actually reduce the impact of that bias.

  - Reducing competition in the market.

28 Ibid, ACCC, p 265.

29 Ibid, p. 250.

A reference bill introduced on its own would impose less (uncontrollable) risk on retailers, as they would not be required to offer the reference bill (or any particular set of prices on which it is based) to end customers. Rather, the retailer would simply need to provide a comparison of the representative outturn bill of the offer (given a specified level of consumption) to the reference bill.

While new entrant retailers often offer the lowest prices in the market, they generally have higher costs to serve and higher costs to acquire customers on a per-customer basis. This complicates the task of setting a regulated unit price for electricity that enables competitive entry without delivering windfall profits to incumbents from their legacy customer base. A reference bill introduced on its own, because it would be a benchmark rather than being based on a price that all retailers must offer (i.e., the default market offer), would avoid this problem, thereby rewarding retailers based on the prices they offer rather than assumptions regarding their average cost of providing electricity to the customer.

- Sacrificing lower prices and enhanced dynamic efficiency gains for the whole market in the mid- to longer term for the sake of immediate bill reductions for a portion of the market in the near term.

  Although a default market offer would provide consumers on standing offers with an immediate reduction in their bills (and a potential but smaller bill reduction for customers on market offers above the default market offer), it is also likely to result in reduced benefits to these customers and the market as a whole in the mid to longer terms. This would be the result of the potential for a default market offer to (a) reinforce consumers' Status Quo bias and (b) reduce the competitiveness of new entrant retailers whose presence generally provides additional innovation and downward pressure on prices. Section 8 explores the impact of these factors in further detail.

- It provides a step-wise approach to addressing the problems that have been observed in the market.

  As discussed in this report, a reference bill could provide many of the benefits available from a default market offer, and be implemented more quickly, at less cost and with less intervention in and down-side risk to the competitive market than the default market offer.

  As such, it provides a logical first step in addressing the problems that have been observed in the market, particularly if certain targeted complementary measures are adopted[30].

  By contrast, implementing a reference bill at the same time and that is linked to a default market offer would:

  - entail more time and costs to implement,

30 It is worth noting that a number of such measures have been implemented since the ACCC report was published, and further measures are under active consideration. Those already implemented include (a) the largest 7 retailers having agreed to contact all standing offer customers and offer them a better deal, (b) the agreement that all retailers will now write to all customers at the expiry of a benefit change and clearly set out the costs of not entering into a new market offer, (c) each of the 'Big Three' retailers announcing automatic discounts for all standing offer customers, or at least concession customers who are on standing offers, (d) retailers notifying standing offer concession customers in NSW twice per year to advise them of the existence of better market offers, and (e) the Victorian government's Energy Brokerage Pilot, which will connect 10,000 low income households with energy brokers to help them find and switch to better energy offers. In addition, there is Rule change pending with the AEMC that would require retailers to contact standing offer customers annually to offer them a better deal.

- impose risks to the competitive market;
- make it very difficult to determine whether the reference bill on its own would have provided sufficient remediation; and
- make it more difficult to move away from regulated prices in favour of a fully competitive market at some point in the future.

7.4. Disadvantages of a reference bill

Whilst a reference bill would make it easier for customers to engage in the market, customers on standing offers would still have to actually do so to get a lower price, as opposed to relying on an instantaneous, 'hard-wired' reduction in prices via an automated move to a default market offer.

Whilst some might argue that the automated move off standing offers is justified in the case of vulnerable customers, as shown in the figure in the ACCC's report that is reproduced in Section 5 above, less than 10% of the vulnerable customers and only about 20% of the other customers in the NEM are likely to be on such tariffs. There are certainly other ways to assist vulnerable customers to gain the benefits of lower cost market offers without incurring the potential disbenefits of the default market offer being imposed on the whole market. As an example, the Victorian government has recently announced the Energy Brokerage Pilot, which will be delivered in partnership with the Brotherhood of St Laurence and connect 10,000 low income households with energy brokers to help them find and switch to better energy offers[31].

One disadvantage of the reference bill as it has been proposed is that it only needs to be referred to by retailers in advertising market offers that include discounts. In our view, it would be better to use the reference bill to provide a benchmark whereby consumers could compare all offers available in the market.

8. The potential financial impacts of a default market offer and a reference bill

In this section we:

- Review the ACCC's quantification of the potential benefits of a default market offer and provide an alternative assessment that we believe is a relevant consideration as to the benefits to standing offer customers, given changes in the market that would be expected to occur in any case; and
- Discuss the potential interactions between the default market offer and the reference bill in the market and offer an alternative assessment of the impact of the reference bill that we believe is more reflective of the market conditions that would actually pertain.

8.1. Review of the ACCC's quantification of the benefits of the introduction of a default market offer and reference bill

On page 368 of its report, the ACCC provides two tables demonstrating the potential financial benefits to:

- Standing offer customers as a result of the introduction of the default market offer; and

31 https://www.premier.vic.gov.au/helping-vulnerable-households-save-on-energy-bills/

- Market offer customers as a result of "*improving competition, improving transparency and making it easier for customers to find a better deal*".

The ACCC's calculation of the annual financial benefits of adopting a default market offer is reproduced below.

Figure 5: ACCC's calculation of the annual benefits ($) of adopting a default market offer

	Vic	NSW	SA	SE Qld
Diff between standing and market offers (AEMC)	330	210	280	212
Saving for each customer moved onto default	165	105	140	106
Standing offer customers	172 000	644 609	92 887	299 477
Total saved	28 380 000	67 683 945	13 004 180	31 744 562
Average per customer (whole market)	**11**	**22**	**17**	**24**

Source: ACCC, *Restoring electricity affordability and Australia's competitive advantages: Retail Electricity Pricing Inquiry - Final Report*, June 2018, p 368.

In relation to the above table, the ACCC notes that its[32]:

> *working assumption for these calculations is an offer that is halfway between current standing offer levels and current market offer levels. This assumption is likely to be conservative as we believe the default offer will be closer to market offer levels. In reality, this saving will be large for standing offer customers but zero for market offer customers but is represented as being averaged across all consumers in the calculations.*

The ACCC's calculation of the potential benefits from introducing a reference bill (for NSW) is reproduced below.

Figure 6: ACCC's calculation of benefits of more effective retail markets

	Discount level							
	None	Up to 5%	5 to 10%	10 to 15%	15 to 20%	20 to 25%	25 to 30%	Over 30%
Average effective price[1009]	29.7	29.2	28.3	26.4	26.3	25.2	23.0	23.3
Proportion of customers[1010]	4.0	8.0	11.0	17.0	31.0	12.0	2.0	0.7
Proportion of customers after switching (assumed)	3.2	6.4	8.8	17.0	31.0	12.0	2.0	5.3
Current implied retailer revenue ($ m)[1011]	220	432	576	830	1507	559	85	30
Implied retailer revenue post-switching ($ m)	176	346	460	830	1507	559	85	228
Change in revenue	-44	-86	-115	-	-	-	-	198

The total change in revenue in NSW is a fall of $47 million. Dividing this by 3.1 million customers gives an average saving of $15 per customer.

Source: ACCC, *Restoring electricity affordability and Australia's competitive advantages: Retail Electricity Pricing Inquiry - Final Report*, June 2018, p 368.

32 ACCC, *Restoring electricity affordability and Australia's competitive advantages: Retail Electricity Pricing Inquiry - Final Report*, June 2018, p 367.

Accompanying the above table (which is for NSW only), the ACCC notes the following points[33]:

> *We have assumed it is achievable to get 20 per cent of customers on market offers with discounts between zero and 10 per cent to move to market offers with discounts of at least 30 per cent. This may be conservative given the range of measures we are recommending……..*
>
> *Using data collected during the Inquiry (shown in figures 1.8, 1.11, 1.14 and 1.17) we have calculated the impact of this switching on retailer revenue (holding prices constant across the market).*

8.2. Factors not taken into account in the ACCC quantification

While the ACCC's analysis is interesting, it does not appear to have given explicit consideration to:

- The bill reductions that standing offer customers could be expected to achieve in the future by switching to market offers, even in the absence of the ACCC's proposed default market offer recommendation, based on the switching rates that have actually taken place in the market over time (a 'do nothing' case), or
- The potential impact on competition from introducing a default market offer, which in turn might impact the benefits accruing from the introduction of a reference bill.

The following two sub-sections present our alternate modelling, taking into account these two areas of concern.

8.2.1. The financial benefits to standing offer customers of the default market offer compared to the 'do nothing' case

It is important to note that the current market arrangements have incentivised customers, over time, to transfer from standing offers to cheaper market offers. This is clearly demonstrated in the historical switching rates that the ACCC presents in its report, as reproduced below.

33 ACCC, op. cit., p 368.

Figure 7: Residential customers on standing offers in non-price regulated jurisdictions, 2014-17

Source: ACCC analysis based on AER data; ESC Victoria data.

Note: The dotted lines indicates a six-month gap between figures (rather than 12 months). Figures for Victoria for December 2017 are not included as the ESC Victoria only reports annually. Figures for south east Queensland prior to June 2016 are not included as reporting to the AER for Queensland only commenced in the 2015–16 financial year.

Source: ACCC, *Restoring electricity affordability and Australia's competitive advantages: Retail Electricity Pricing Inquiry - Final Report*, June 2018, p 244.

This steady reduction in customers on standing offers is almost certainly going to continue, if not increase across all jurisdictions into the future under a do-nothing case. We say this because the historical declines in customers on standing offers do not reflect the:

- Dramatic interventions into the electricity market over the last 6 months (see footnote 30 above), which, everything else being equal, will only increase the level of switching from standing offers to market offers; or even
- The ACCC's own recommendation regarding the adoption of a reference bill, which is designed to improve the operation of the market, including, presumably, for those currently on standing offers.

In short, even without the ACCC's proposed default market offer, the empirical information available suggests that standing offer customers will continue to switch to market offers in the future to reap the financial benefits of a lower bill.

To model the impact of this 'do nothing' outcome as compared to the ACCC's modelled benefits of introducing a default market offer, we have simply compared the savings that the introduction of the default market offer would provide over the next five years with those that could be expected to accrue to these customers under the assumption that observed historical switching rates from standing offers to market offers continues.

Savings achieved by standing offer customers from the default market offer

Table 1 below replicates the ACCC's analysis. It calculates the annual savings resulting from all current standing offer customers moving immediately to the default market offer, and the present value of those savings over five years.

Table 1: Reproduction of the ACCC's modelled benefits from introducing a default market offer

State	No. of Standing Offer Customers	Annual $ bill redn – SO to MDO	Year 1 ($m)	Year 2 ($m)	Year 3 ($m)	Year 4 ($m)	Year 5 ($m)	NPV* ($m)
NSW	644,609	$105	$67.68	$67.68	$67.68	$67.68	$67.68	$293.54
QLD	299,477	$106	$31.74	$31.74	$31.74	$31.74	$31.74	$137.67
SA	92,887	$140	$13.00	$13.00	$13.00	$13.00	$13.00	$56.40
VIC	172,000	$165	$28.38	$28.38	$28.38	$28.38	$28.38	$123.08
TOTAL								**$610.69**

Source: OGW analysis based on ACCC figures; *Assumes mid-year cashflow timing.

Savings achieved by standing offer customers moving to market offers over time based on observed historical switching rates

Table 2 calculates the annual financial benefits that could be expected to accrue to standing offer customers from moving to a market offer at rates similar to those that have been observed in the market to date. In this case, the calculation assumes that, by switching, the customer realises the full benefit identified by the ACCC as representing the difference between the standing offer and market offers in each of the jurisdictions (see the first row in Figure 3). As a result, the saving is twice the amount in Table 1 above because the ACCC assumes that the default offer will be at a price that is midway between the average standing offer and the market offer available in each jurisdiction at the time the report was undertaken.

Table 2: OGW's modelled financial benefit to standing offer customers assuming a 'do nothing' scenario

State	No. / % of Standing Offer Customers	Annual bill redn – SO to MO	Year 1 ($m)	Year 2 ($m)	Year 3 ($m)	Year 4 ($m)	Year 5 ($m)	NPV* ($m)
NSW	644,609 (21%)	$210	$32.2	$64.5	$83.8	$103.1	$109.6	$331.2
QLD	299,477 (22%)	$212	$17.3	$31.7	$40.4	$49.1	$51.9	$160.8
SA	92,887 (12%)	$280	$4.3	$8.7	$13.0	$15.2	$17.3	$49.1
VIC	172,000 (7%)	$330	$16.2	$24.3	$32.4	$32.4	$32.4	$117.5
TOTAL								**$658.6**

Source: OGW analysis based on ACCC figures; *Assumes mid-year cashflow timing.

The switching rate from standing offers to market offers assumed in Table 2 over each of the next five years is broadly based on projecting forward historical switching rates. It is worth noting again that this projection does not include any explicit increase in the switching rate due to any other measures including the measures that have been introduced since the ACCC's report was published, or the possible introduction of a reference bill. Table 3 shows the percentage of customers that are assumed to remain on standing offers in each of the five years based on that forward projection of historical switching rates.

Table 3: Percentage of customers assumed to be on standing offers

Jurisdiction	June 2014	June 2015	June 2016	June 2017	2018	2019	2020	2021	2022
	% Actual				% Estimated				
NSW	36	30	25	21	16	11	8	5	4
QLD			26	22	16	11	8	5	4
SA	16	15	14	12	10	8	6	5	4
VIC	11	10	9	7	5	4	3	3	3

Source: ACCC figures, OGW extrapolation of historical data.

Based on the assumed switching rates in Table 3, it would appear that the short-term bill reductions accruing to standing offer customers as a result of the introduction of a default market offer are materially less (around $48m in NPV terms, based on the NPV for the do nothing case of $658m compared to the NPV of the ACCC's case of $610m) than what those customers would be forecast to achieve under a do nothing case.

To be clear, the above analysis assumes that once a customer has moved to the regulated default market offer, that customer would not subsequently proactively switch to a market offer.

To this end, for the implementation of the default market offer to break even (in NPV terms) with the do-nothing case, around 15% of the customers that we have assumed would have switched in the future under the 'do nothing' case[34] would need to now choose to switch to a market offer in the future, even though they will have recently been moved to a regulated default market offer.

Whilst it is impossible to know for sure what customers may or may not do in the future, we doubt that such a substantial number of customers would proactively switch within the next few years after having already been moved to a default market offer (and having expended no effort to do so), given that:

- The benefits of any further switching will have reduced materially (in fact, halved based on the ACCC's figures);
- These customers have already demonstrated a propensity to not want to switch in the first place, and will have achieved a significant bill reduction without having engaged with the market due to their automatic transfer to the default market offer; and
- These customers may reasonably be expected to perceive there to be some benefit to being on a 'regulator-approved' default market offer.

34 Essentially, we would have to assume that 11% of the customers who would have been automatically currently on a standing offer and who would have been automatically transferred to the default market offer would need to make a subsequent decision to move to a market offer.

8.2.2. The potential for the default market offer to impact the benefits to be realised from the introduction of a reference tariff

We think it is entirely reasonable for the ACCC to assume that, with the introduction of a reference bill, "*it is achievable to get 20 per cent of customers on market offers with discounts between zero and 10 per cent to move to market offers with discounts of at least 30 per cent*", everything else being equal.

However, everything else ***is not*** equal, in that the adoption of a default market offer may impact future levels of competition in the market, hence impacting the benefits accruing from the adoption of a reference bill. This is precisely the impact that IPART noted, as discussed at the end of Section 7.2.2 above.

In particular, for the ACCC's outcomes to be achievable, they don't just need a reference bill, but also, a flourishing, underlying competitive market. For the reasons outlined earlier in this report, we think the adoption of a default market offer, particularly one that makes no allowance for headroom, is quite likely to reduce competition in the market.

In Table 4 below, we have adopted exactly the same assumptions and workings as the ACCC did in calculating the benefits to NSW customers on market offers of the introduction of a reference bill. The only difference in our analysis is that we have assumed that market offers start to converge to the middle. That is:

- The "bad" offers are effectively removed due to the adoption of an "efficient" default market offer; *and*
- The "really good" offers are also removed due to the impact that the default market offer has on future competition.

More particularly, we assume that no market offers would subsequently be available with an effective discount of 20% or more[35], and that no customers would be on non-default market offers with an effective discount of less than 5%. We have skewed the remaining offers towards the higher end of the remaining discount levels, by assuming more customers are on a 15-20% discount as compared to a 5-10% discount[36].

Table 4: Potential impact of reduced competition on the ACCC's modelled reference bill benefits

Parameter	None	Up to 5%	5-10%	10-15%	15-20%	20-25%	25-30%	Over 30%
Average effective price	29.7	29.2	28.3	26.4	26.3	25.2	23	23.3
Proportion of customers	4	8	11	17	31	12	2	0.7

35 Interestingly, on page 144 of its report, the ACCC acknowledges this potential outcome when it states that: "One consequence of this [the ability of customers to easily compare retail electricity offers] may be that some of the lowest offers available now will no longer be accessible, and consumers who seek out those offers may end up paying more for electricity. However, the consumers who are benefiting today from these very aggressive retention offers may be doing so at the expense of other consumers who are paying too much".

36 More specifically, we have assumed that 20%, 50% and 30% of market offer customers respectively would migrate to offers with discounts of 5-10%, 10-15% and 15-20% respectively. Applying those percentages to the 85.7% of customers that are on market offers in NSW results in the figures highlighted in grey in Table 4.

Proportion of customers after switching (assumed)	0	0	17.14	42.85	25.71	0	0	0
Current implied retailer revenue ($m)	$221	$434	$579	$835	$1,516	$562	$86	$30
Implied retailer revenue post-switching ($m)	$-	$-	$902	$2,104	$1,258	$-	$-	$-
Change in revenue ($m)	-$221	-$434	$323	$1,269	-$259	-$562	-$86	-$30

Source: ACCC figures, OGW forecasts.

Under these assumptions, the impact on retailers' total revenues (the total of the bottom row) is essentially zero (actually $-0.06m). This would occur as customers currently on 'attractive' market offers would pay more for their electricity in total, with this offset by customers on high market offers paying less in total.

To be clear, the intent of this analysis is not to present a precise forecast or point estimate of the impact, rather, it is simply to demonstrate that:

- The two recommendations made by the ACCC should not be assessed in isolation of one another, particularly if one subscribes to the view that re-regulating electricity prices (via the adoption of a default market offer) may have a negative impact on retail competition. To this end, the greater the AER's focus is on setting the default market offer to perfectly reflect "efficient" costs, the better off existing standing offer customers will be from moving to the default offer[37] (thus affecting our earlier analysis of the benefits to standing offer customers), but the worse off some market offer customers might be due to the reduction in competition and its impact on the offers available in the market (thus affecting our analysis above); and
- Any convergence in retail offers is likely to lead to a wealth transfer from those customers who have previously sought out and are on "attractive" market offers, to those customers that have, for whatever reason, not moved to 'attractive' market offers, rather than from retailers to customers in totality[38].

37 We note that the ACCC states that it believes its calculations of the benefits to standing offer customers is conservative, as it believes "the default offer will be closer to market offer levels". If this is true, the greater will be the potential risk to retail competition.

38 Again, this is something that appears to be acknowledged by the ACCC in its report (page 144).

9. How a reference bill that is introduced on its own could be calculated and implemented in practice

In theory, a reference bill could be any number, as it simply represents a common basis for measuring discounts. However in practice, it is likely to be built up based on an estimate of an efficient retailer's input costs[39]. This would almost certainly be done by distribution region, as each distribution business has different tariffs, hence retailers incur different costs to serve customers in different regions.

Whilst this may sound complex, the AER would be required to do something even more complex to derive a default market offer. The fundamental difference in this regard is that the AER would not need to be absolutely precise when it comes to formulating the price on which the reference bill is based, as it is a tool to facilitate the efficient functioning of the market (it is not intended that it replace market outcomes), whereas it would need to be absolutely precise if it were to create a default market offer.

The creation of a reference bill would only need to be undertaken for the most common tariffs (e.g., flat rate tariffs, two rate tariffs). Those seeking to go onto more innovative tariffs could use the comparison websites that are available, most notably, *Energy Compare* in Victoria (www.compare.energy.vic.gov.au) and *Energy Made Easy* in all NEM jurisdictions (www.energymadeeasy.gov.au). This would also result in these customers becoming more knowledgeable participants in the retail energy market.

In our view, the introduction of an easy to understand reference bill in combination with the increasing ability of the comparison sites to use individual customer billing data in assessing the available – rather than re-regulation of prices – offers the best means for reducing the transaction costs and confusion that many customers experience in today's retail electricity market, and enhancing the longer-term efficiency and innovation benefits available from competition.

39 Even if retailers' costs were to be ignored in developing the benchmark, some thought would probably need to be given to the impact that the sign and magnitude of the comparison figures resulting from the benchmark would have on competition. For example, a benchmark in which the vast majority of market offers have negative discounts could provide as accurate a comparison tool as a benchmark that resulted in spread of positive and negative discounts – but the two could result in different impacts on the competitive market. This is an implementation detail and can readily be addressed.