AEMC

REVIEW

Australian Energy Market Commission

FINAL REPORT

ADVICE TO COAG ENERGY COUNCIL: CUSTOMER AND COMPETITION IMPACTS OF A DEFAULT OFFER

20 DECEMBER 2018

INQUIRIES

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ABOUT THE AEMC

The AEMC reports to the Council of Australian Governments (COAG) through the COAG Energy Council. We have two functions. We make and amend the national electricity, gas and energy retail rules and conduct independent reviews for the COAG Energy Council.

SUMMARY

1 At its 26 October 2018 meeting, the COAG Energy Council requested that the Australian Energy Market Commission (AEMC or Commission) analyse the impacts of the Commonwealth's proposed default tariff.[1] This included advice on competition issues and customer impacts including price for both standard and market customers in relevant jurisdictions.

2 In its tasking letter of 12 November 2018 to the AEMC on behalf of the COAG Energy Council, the Senior Committee of Officials (SCO) specified how the default offer was proposed to be set in more detail. The SCO indicated that the default offer rate is a price cap set by the Australian Energy Regulator (AER) imposed on standing offers with a flat rate tariff structure and offered by all retailers authorised in competitive markets. The SCO specified that the cap will be based on the efficient cost of operating in each network region, including a reasonable return on investment, as well as the cost to serve customers, and customer acquisition and retention costs (CARC). The cap would apply to residential and small business customers for each network region in New South Wales, South Australia and South East Queensland.

Default offer

3 The ACCC released its *Retail electricity pricing inquiry final report* in June 2018. The ACCC recommended the introduction of a default offer for two reasons:

1. to cap unreasonably high prices currently paid by disengaged or uninformed customers on standing offers
2. it would be used to calculate a reference bill from which all retailer discounts must be calculated, and would therefore address the difficulty customers face in comparing different retail market offers — the "discounts off what" issue.

4 In October 2018, the Treasurer, the Hon Josh Frydenberg MP, and the Minister for Energy, the Hon Angus Taylor MP, requested that the AER develop a price for the default offer by 30 April 2019, to be implemented on 1 July 2019. On 9 November 2018, the AER released a discussion paper on this work outlining a proposed approach to calculating the default offer. This proposed approach included a range of possible price levels for the default offer.

Current standing offer landscape

5 In undertaking an assessment of the likely effects of the introduction of the default offer, the Commission has first sought to provide a picture of the current standing offer landscape. This includes the number and type of customers on standing offers, the various price levels of standing offers relative to market offers and trends in these factors over time.

6 Standing offers are generally set at price levels higher than market offers. A very common feature of market offers are conditional discounts, such as pay on time or direct debit discounts. These discounts are generally off standing offer rates.

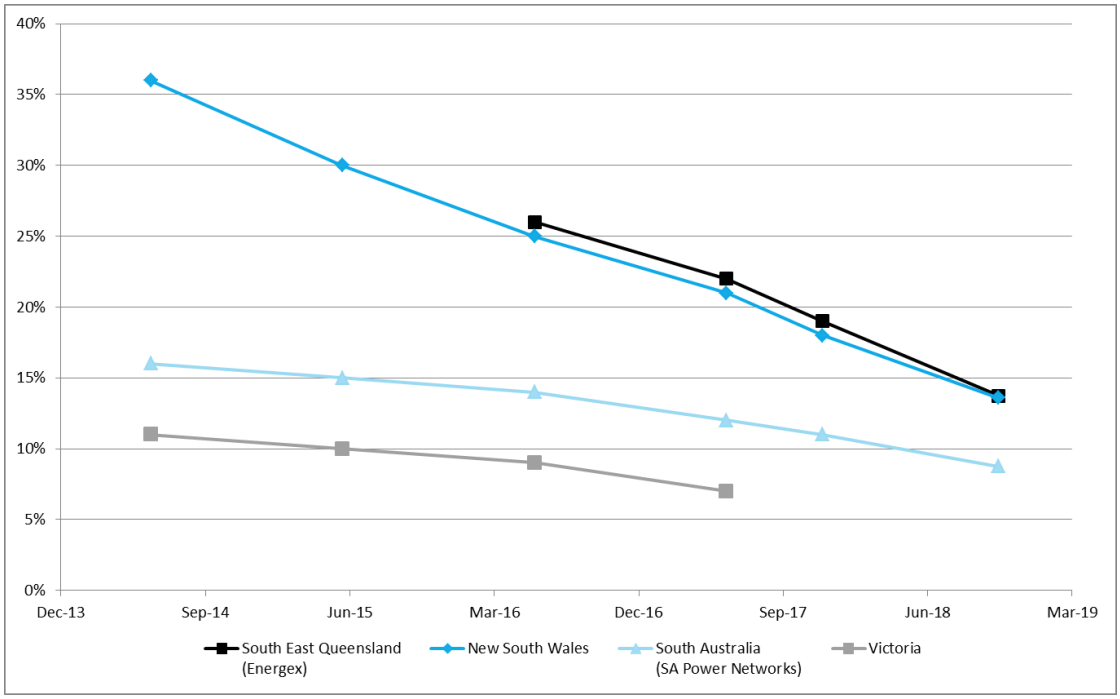
7 The Commission has observed in retail energy competition reviews that standing offers have

1 COAG Energy Council, *20th Meeting Communique*, Friday 26 October 2018.

increased at a faster rate than market offers in recent years.[2]There has also been an increase in divergence between retailers' standing offers, with higher priced standing offers increasing significantly, particularly for tier two retailers.

8 Figure 1 below shows the trends in the proportion of residential customers on standing offers over time.

Figure 1: Percentage of residential customers on standing offers



Source: 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.

9 Figure 1 shows that the proportion of residential customers on standing offers has decreased over time in all jurisdictions which have removed price regulation. It also displays that this rate of decrease has not been slowing in recent times. All jurisdictions are likely to have less than 10 per cent of residential customers on standing offers within the next two years. The Commission also notes that there exists a segment of the market (approximately two to four per cent of all residential customers) who are on standing offers for a short period when they move house or create a new connection and have not yet selected a market offer.

10 While there is a strong overall trend of customers moving away from standing offers, analysis within this cohort demonstrates that there are specific groups of customers who have not responded to the availability of lower market offers. In particular, higher proportions of rural

2 For the most recent example, see: AEMC, *2018 Retail energy competition review: Final report,* June 2018, p. 72.

and small business customers remain on standing offers.

11 In contrast, the percentage of hardship customers on standing offers is approximately half that of all other residential customers.

Short-term risks of the default market offer

12 Assessing the likely effects of the introduction of a default offer is, by its nature, a prediction of the reaction of retailers and customers to a form of price regulation. To provide an indication of such effects the Commission notes the following:

- The retail market is workably competitive, with no evidence of excessive retailer margins:
  - The ACCC made no reference in its *Retail Electricity Pricing Inquiry* that retail margins are inefficient or that retailers are earning excessive profits.[3]
  - The ACCC noted that signs of a competitive market are present with a proliferation of offers, high levels of churn and extensive marketing.[4]
  - This suggests that retailers are operating in a workably competitive market and that retailers are unlikely to fully absorb a margin squeeze between costs and regulated retail prices.
- Within this workably competitive market, retailers use market segmentation to compete:
  - The ACCC noted in its *Retail Electricity Pricing Inquiry* report that retailers deploy significant resources to segment existing and potential customers into different categories. The ACCC also noted a number of ways in which retailers compete for valuable customers through market segmentation.
  - These strategies included intentionally increasing prices for inactive customers and increasing prices to turn low value customers into high value customers or prompt them to move to another retailer. This segmentation suggests that retailers' response to the introduction of the default tariff is likely to be changes in their market offers.
- The characteristics and operation of retail markets more broadly with and without price regulation.
  - Analysis across the AEMC's multiple retail energy competition reviews has consistently demonstrated that jurisdictions with price regulation experience lower levels of price dispersion than those without price regulation. This is also consistent with the international experience. For example, KPMG notes:[5]

> "[J]urisdictions that have re-introduced stronger controls on tariffs in response to concerns about the retail market, whether price controls or non-price tariff regulation, have typically experienced a fall in diversity of offers and activity. The impact on price has varied between customer types. Introducing more restrictive regulations are likely to benefit some customers to the detriment of others."

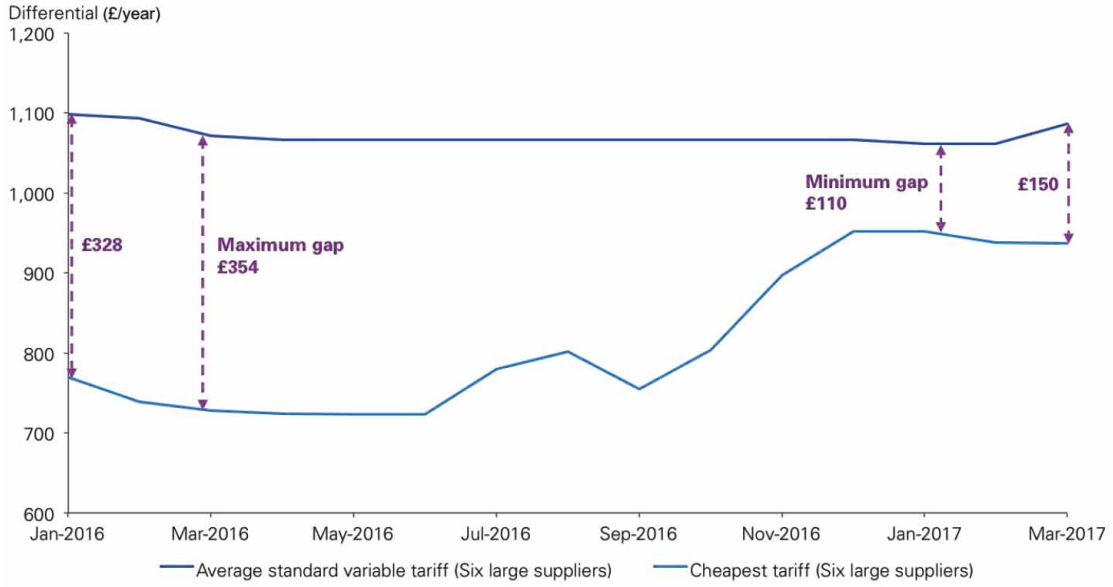
3 ACCC, *Retail Electricity Pricing Inquiry - Final Report,* June 2018, ACCC, see Chapters 6 and 10.

4 ibid

5 KPMG, *Energy retail markets: An international review*, April 2017, p. 8.

- The United Kingdom's (UK) experience in re-introducing price regulation through a temporary default offer cap involved price compression:
  - Following the announcement of the default cap in June 2016, a significant reduction in price dispersion has occurred in the UK.
  - Figure 2 below shows KPMG's analysis of the reaction of the largest six retailers in the UK to the proposal.

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.

13 Further, the Commission considered the likely range of default offer price levels set out in the AER's proposed approach paper to model the likely response of the market to the default offer.

14 Noting that there is a reasonably wide variation in retailers standing offer, it could be expected that where a default offer is set below a retailer's standing offer, the retailer would attempt to recover lost revenue by raising market offer prices. Whether an individual retailer is successful in this attempt largely depends on the impact of the default offer on the relative prices offered by competitors and the response of the retailer's market offer customers. In general, it could be expected that not all of the lost revenue would be recovered through increasing market offer prices. Similarly, in a real world workably competitive market, as distinct from the textbook purely competitive market, it is reasonable to expect that some of it will be, and hence no customer on market offers would face increased prices.

15 Hence, a key assumption in the modelling undertaken by the AEMC is how retailers respond to a decrease in revenue from standing offer and higher priced market offer customers following the introduction of a capped default offer. Based on the ACCC's analysis of retailer profitability and pricing behaviour, international examples of the re-introducing price

regulation and observations of outcomes in regulated and deregulated markets it is likely that retailers will respond to the introduction of the default offer by attempting to increase market offers.

16 The extent to which revenue can be successfully recovered is uncertain and the Commission has therefore modelled a range of scenarios. For illustrative purposes, the Commission has presented the results of a 50 per cent revenue recovery in this advice. That is, where retailers increase their market offers such that they recover half of the lost revenue from the introduction of the default offer. *It should be emphasised that this scenario is for illustrative purposes. It is not a prediction of the consequences of a hard cap default offer, the level of which has yet to be determined. Rather, in the absence of a specific default offer price and estimates of the price elasticity of demand for different customer segments, it serves to illuminate the risks associated with the introduction of the type of default offer the AEMC has been asked to consider.*

17 This analysis, which is based on the assumptions noted above, indicates that the introduction of a default offer potentially results in:

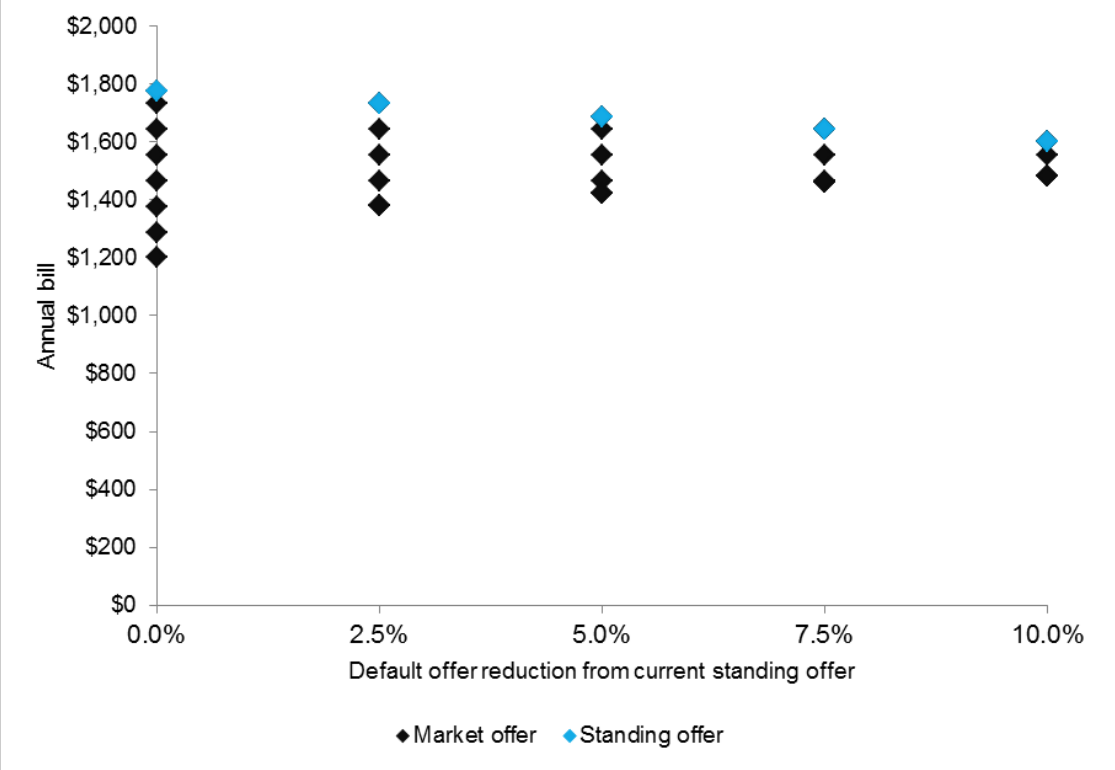
- a decrease in price dispersion in the market from a:
  - reduction in the price of standing offers
  - reduction in the price of high priced market offers
  - price increases in the lower priced market offers available to customers
- customers on standing offers and market offers that were above the default offer would be better off
- customers on lower priced market offers would be worse off.

18 The effects for New South Wales are displayed in Figure 3. In South Australia the magnitude of price conversion is similar to New South Wales. In South East Queensland the magnitude is more sensitive than in New South Wales.

19 Figure 3 shows that a default offer set 10 per cent below the current average standing offer could result in a 23.6 per cent increase in the lowest market offer bills. In South Australia, a default offer set 10 per cent below the current standing offer price would increase the lowest market offers by 25.8 per cent. For South East Queensland, convergence occurs faster than South Australia and New South Wales:

- If the level of the default offer in South East Queensland is set at 10 per cent below the current average standing offer, the only way for retailers to recover 50 per cent of their revenue shortfall would be to set market offers above the default offer. This is clearly not a feasible outcome, but does illustrate the potential detrimental implications for retail competition if the default offer is set too low.
- A default offer set five per cent below the current standing offer in South East Queensland would result in a 30.8 per cent increase in the lowest market offer bills.

Figure 3: Range of offers under default offer - New South Wales



Source: AEMC analysis

Implementation issues

20 Irrespective of the magnitude of the impact on market offers from the introduction of a hard cap default offer, there are potential detrimental effects on consumers of the proposed implementation process. The proposed timeframes and processes for implementation of the default offer on 1 July 2019 risk causing disruption and confusion for customers and costs for retailers to meet the new obligations. For example, the predominant form of existing market offers are discounts off standing offers. Contractually the price paid by the customer is therefore tied to the standing offer price. If standing offers are reduced through the default offer and retailers seek to avoid a corresponding decrease in the absolute price level of their market offers they would need to alter their existing contracts with customers.

21 For example, an existing customer on a market offer with say a 20 per cent discount off their retailer's standing offer is paying an average price of say 28c/kWh. Given the terms of the contract, if the retailer's standing offer was reduced by 10 per cent, the reduction would flow through to the market offer contract price. If the retailer wished to keep the customer at the same 28c/kWh price level, it would need to convince the customer that while their discount had reduced, their price was the same. To the extent that this proves too difficult it might add further pressure for the retailer to withdraw its lower priced market offers.

22 Without sufficient lead time and transitional arrangements the risk is that engaged consumers, despite not being directly impacted by the default offer, will be detrimentally affected and may therefore be inclined to become disengaged. This may be exacerbated in the current environment of low trust in the sector.

23 Depending on the price level set by the AER there may be significant disruption for customers and the market. There is a risk that these costs will be passed through to customers through higher average price levels.

Long-term risks of the default market offer

24 In addition to the short-term effects, the Commission has analysed the likely longer term structural effects of the introduction of a default offer. There are likely to be three major effects:

1. increased risk to retailers driving higher financing and overall costs
2. lower levels of innovation leading to less available products and services
3. higher barriers to entry and changes to consumer behaviour resulting in decreased competition.

25 Price regulation of any good or service changes the risks faced by suppliers of the good or service. This applies for both existing suppliers and potential suppliers considering entering the market. Electricity retailers raise funds for investment and operating purposes in highly competitive capital markets. These markets assess the risks associated with the nature of the businesses operations and feed this risk assessment into the price at which capital is made available.

26 With prices capped by the default offer, retailers will face greater risks because they will not have control of the price levels at which they sell energy and other services. In particular, if costs rise in excess of the price cap they may not be able to pass these cost increases through to consumers. This is a particular concern for electricity retailers in the context of increasing volatility in wholesale prices making forecasting of their input costs difficult.

27 The default offer could inhibit innovation in electricity retail markets, particularly price based innovation. The default tariff would lock in a small number of tariff structures as central to retail price setting and advertising for the whole market. This would make it more difficult for retailers to market other pricing structures and products to customers. KPMG, in its *Energy retail markets: an international review,* drew similar conclusions from observation of international retail markets. In particular, KPMG noted that while passive customers may benefit, markets with price regulation tend to exhibit limited diversity in terms of new business models or new products and services.[6]

28 These risks are most pertinent to small and new entrant retailers. These retailers tend to exhibit lower levels of vertical integration in generation and therefore tend to be more exposed to wholesale price changes. Caps on prices are therefore likely to represent a larger risk to these retailers. Smaller retailers also tend to be more reliant on product innovation to gain market share.

6 ibid.

29 The reduction in price dispersion may also have an effect on consumer behaviour. In its retail energy competition reviews, the Commission has highlighted that customer switching and engagement in retail markets is often driven by substantial differences between consumers' existing offers and the market offers they can achieve by switching. In the long run, where price dispersion reduces, decreased engagement from customers is likely to decrease the share of active customers in the market. A lower share of active customers is likely to lead to less competition in the market.

30 Similar outcomes have been observed with the re-introduction of price regulation in Ontario. KPMG has noted that while re-regulation reduced price volatility, the competitive market shrunk. Switching rates in Ontario went from twenty five per cent of customers switching to a competitive provider prior to the price freeze to just six per cent of customers following re-regulation.[7]

Conclusion and alternatives

31 The ACCC proposed the introduction of a default offer as a means of addressing the dual problems of high standing offers and a lack of comparability of retail market offers.

32 Updated figures since the publication of the ACCC report demonstrate that there is a strong trend of declining proportions of customers on standing offers in New South Wales, South Australia and South East Queensland. It is likely that less than 10 per cent of customers will remain on standing offers within the next two years in each jurisdiction. Based on the declining proportion of customers on standing offers and the short and long term risks associated with the default offer, the Commission considers that caution should be exercised in introducing the default offer as a regulated price cap.

33 In the short-term, the Commission considers that there are more prudent specific solutions available that assist customers to compare market offers. This includes a number of reforms that are under way. For example, the ACCC's work on the consumer data right and improvements to the regulation of energy comparison site services. Further to this, a comparison rate or soft cap default offer should be developed as a "do no harm" approach to solving the "discounts of what" issue.

34 A comparison rate would facilitate customers comparing the wide variety of market offers available. This is particularly important in the current context of retailers predominantly using discounts off varying standing offer rates. It would also potentially "take the froth off standing offer prices" by limiting the practice of retailers setting artificially high standing offers. That is, because retailers would be required to compare their standing and market offers to the comparison rate, the incentive to inflate standing offers to advertise large discounts in their market offers will be removed.

35 As part of its 2019 retail energy competition review, the Commission will provide advice to the COAG Energy Council on how to design a comparison rate. This advice be provided by March 2019 and would leverage off the design work on the default offer that the AER has and is continuing to carry out.

7 ibid.

36 As part of this, the Commission will provide advice on actions to assist those sub-groups of customers (e.g. rural and small business customers) that have higher than average proportions remaining on standing offers. This work will build on the AEMC Consumer Blueprint which highlighted and identified the various channels needed to effectively communicate across and within consumer segments.[8]

37 In the short term, these proposed solutions are likely to address the problems of unreasonably high standing offers and a lack of comparability between market offers. However, they would do so with fewer risks to so called "engaged" customers, and retail competition and innovation, than introducing a hard cap default offer of the nature specified in the tasking letter from SCO on behalf of the COAG Energy Council. If, after 12 months, the COAG Energy Council still sees issues with the standing offers, the default offer could be revisited, with the comparison rate serving as the basis on which a default offer could be considered.

8 AEMC, *Empowering consumers: A blueprint for informing and empowering small consumers in NSW energy markets,* October 2013.

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APPENDICES

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1 CONTEXT FOR THE DEFAULT OFFER

At is 26 October 2018 meeting, the COAG Energy Council requested that the Australian Energy Market Commission (AEMC or Commission) analyse the impacts of the Commonwealth's proposed default tariff.[9] This included advice on competition issues and customer impacts including price for both standard and market customers in relevant jurisdictions.

1.1 Introduction

1.1.1 The COAG Energy Council's request

In its tasking letter of 12 November 2018 to the AEMC on behalf of the COAG Energy Council, the Senior Committee of Officials (SCO) requested that the AEMC provide advice on the impacts of the proposed default offer on competition and small consumers, including price for both standard and market offer customers across the states and territories of the national electricity market (NEM) where prices are currently deregulated. This does not include Victoria, which is pursuing a default offer in its own right.

For the purpose of this work, the SCO indicated that the Commonwealth's proposed default offer rate is understood to be:

- a price cap set by the Australian Energy Regulator (AER) imposed on standing offers with a flat rate tariff structure and offered by all retailers authorised in competitive markets
- set for each network region where retail prices are deregulated (New South Wales, South Australia and South East Queensland)
- based on the efficient cost of operating in each network region, including a reasonable return on investment, as well as the cost to serve customers, and customer acquisition and retention costs (CARC)
- applied by retailers in circumstances where a standing offer is set by the individual retailer and applied to small customers (residential and small business customers).

A copy of the tasking letter from SCO is included as Attachment A.

1.1.2 Australian Energy Regulator's work on the default offer

In October 2018, the Treasurer, the Hon Josh Frydenberg MP, and the Minister for Energy, the Hon Angus Taylor MP, requested that the AER develop a price for the default offer by 30 April 2019, to be implemented on 1 July 2019. This includes a mechanism for determining a reference bill amount for each network distribution region, from which headline discounts can be calculated. The AER is required to publish its final determination for the default offer prices and the reference bill by 30 April 2019.

On 9 November 2018, the AER released a discussion paper on this work outlining its preliminary views on the proposed pricing methodology for determining the default offer. The AER's preliminary view is that the default offer will be:

9 Also referred to as a default offer or default market offer.

- a maximum price for standing offers
- determined initially using a top down approach (which may be followed by a bottom up approach in future)
- within the range of the median standing offer and the median market offer in each distribution zone as at October 2018
- set for a flat rate tariff and a flat tariff with controlled load for residential customers, and a flat rate tariff for small businesses
- an annual bill estimate for a representative consumer within a distribution zone.

For the purposes of this advice, the AEMC has used the AER's preliminary views as a basis for the analysis on the impacts of a default offer. The analysis in Chapter 3 on the impact on pricing strategies uses the median standing offer based on the AER's assumptions and is consistent with its views on where the default offer is likely to sit.

1.1.3 AEMC's advice to COAG Energy Council

This advice is limited to New South Wales, South Australia and South East Queensland. The analysis does not include customers of exempt sellers.

The advice describes:

- the context for a default offer and the Australian Competition and Consumer Commission's (ACCC's) rationale for the default offer
- the current landscape of standing offer and market offer customers
- potential short and long term impacts of introducing a default offer
- an alternative to the proposed approach, and other initiatives to improve consumer outcomes.

1.2 Context for a default offer

There were large electricity price rises in most jurisdictions of the NEM in 2017-18. These were mainly driven by a tightening of the supply-demand balance and higher fuel costs for coal and gas generators. Queensland was an exception to this general trend.

Despite South East Queensland pricing remaining relatively flat, the broader NEM price rises led to concerns about the affordability of consumer energy services.

Against that background the AEMC released its *2018 Retail Energy Competition Review.* This described problematic dimensions of energy pricing as:

- the large number of offers, and that the offers are unrelated to market segmentation, such that there is likely to be a misallocation issue where many customers are not on a plan suited to their circumstances
- that, across offers, discounts are from varying bases and calculated on potentially different parts of the tariff creating a "discounts off what?" challenge for consumers

- that the scale of discounts are unrelated to the cost of the behaviours being addressed or encouraged. For example, the loss of discounts for late payment can be many times the actual cost to the retailer of a customer paying late.

This section outlines the ACCC's default offer proposal, within the following structure:

- the purpose of a default offer — what is it intended to achieve?
- setting the default offer price — the ACCC's view.

1.2.1 The purpose of a default offer

The ACCC's *Retail Electricity Pricing Inquiry Final Report* identified, what it considers to be, a number of issues with standing offers and concluded that standing offers are no longer fit for purpose. It further considers that there is a need for a default offer to protect consumers who:

- have never chosen a market offer
- do not select a new offer prior to the expiry of an existing offer
- were switched through a retailer-of-last-resort process.

A default offer would also act as a price ceiling for exempt networks in a region.

The ACCC recommended that standing offers be replaced with default offers for each network distribution area in jurisdictions where prices are not regulated. It should include "simple pricing, minimum payment periods, and access to bill smoothing and paper bills".[10]

The default offer would be determined by the AER and set the maximum price in any distribution area. In the ACCC's view, the two primary benefits of the default offer would be that:

- it would cap the 'loyalty tax' that disengaged customers have to pay
- it would be used to calculate a reference bill from which all discounts must be calculated, and so would therefore address the 'discounts off what' issue.

1.2.2 Setting the default offer price - ACCC view

The ACCC notes that setting the price of default offers is ultimately a matter for the AER. However, it did provide its views that the default offer:

- would be the maximum price in each distribution zone
- should not be the lowest market price, nor close to the lowest, as it is a fall-back price for the disengaged
- should be based on the efficient costs of supply, consumer protections, a "reasonable" margin, and include CARC.

On this basis, it considers the price is likely to be between the median market and median standing offer prices, but closer to the median market offer.

10 ACCC, *Retail Electricity Pricing Inquiry - Final Report,* June 2018 p. 246.

The ACCC specifically addressed the inclusion of CARC to highlight the difference between the default offer and the proposed Victorian basic service offer (BSO) where CARC costs were excluded. While the Victorian government has since indicated that a modest allowance for CARC will now be included in its proposed Victorian Default Offer, in the ACCC's view, the removal of CARC costs would create a risk to market innovation, and the continued operation of smaller retailers who seem to drive innovation more than their larger rivals. It may also remove the incentive for consumers to engage with the market if they feel the default offer is around the best in the market.

If done correctly, the ACCC considers the default price will reduce retailers' costs, and find a balance between incentivising consumer participation in competitive markets and preventing unfair penalties being imposed on the disengaged.[11]

In relation to regional Queensland, where retail prices are recommended by the Queensland Competition Authority (QCA), the ACCC consider there is a need to retain the current standing offer.[12] It notes that the QCA uses an approach to price setting that is similar to the one it suggests the AER should use.

11 The ACCC considers the restriction on changing standing offer prices more than once every six months and the obligation to publish standing offer prices in newspapers and the Victorian Government Gazette can be removed if its recommendations are adopted. Neither of these cited reasons is likely to reduce retailer costs materially.

12 The ACCC considered standing offers should remain in all price-regulated jurisdictions. So in addition to regional Queensland, standing offers would continue in Tasmania and the ACT.

2 CURRENT LANDSCAPE

The default offer is proposed to cap the price of standing offers. To be able to assess the competition effects and likely effects on small customer from the introduction of a capped default offer, it is important to have a clear picture of the existing standing and market offer landscape. This chapter provides that information. It is broken down into:

1. What are standing and market offers?
2. What price levels are standing offers currently set at relative to market offers?
3. How many customers are on standing offers and market offers?
4. What are the characteristics of customers on standing offers?
5. Recent changes to standing offers.

2.1 Standing and market offers

Retailers must publish on their websites a standard retail contract (standard contract) for all distribution zones in NEM regions that they operate in.[13] Retailers' standard retail contracts must adopt the model terms and conditions in the National Energy Retail Rules (NERR).[14] These terms and conditions include:

- retailers must inform customers about price increases
- prices cannot change more than once every six months
- there is a minimum amount of time before customers can be disconnected if they do not pay their bill.

Each consumer has a designated retailer that is required to offer to supply them under the retailer's standard retail contract.[15] The obligation to supply applies to residential and small business customers and allows them to access an offer from at least one retailer. Standing offers are offers to supply in accordance with the standard retail contract at the price set by the retailer.

When full retail contestability was introduced, retailers could also offer retail market contracts (market contracts) which allow them to determine most of the terms and conditions in the contract.

2.2 Pricing of standing and market offers

This section provides information regarding pricing levels of standing and market offers. Market offers are generally significantly cheaper than standing offers. A very common feature of market offers are conditional discounts, such as pay on time or direct debit discounts. These discounts are generally off standing offer rates, which are not consistently set across retailers.

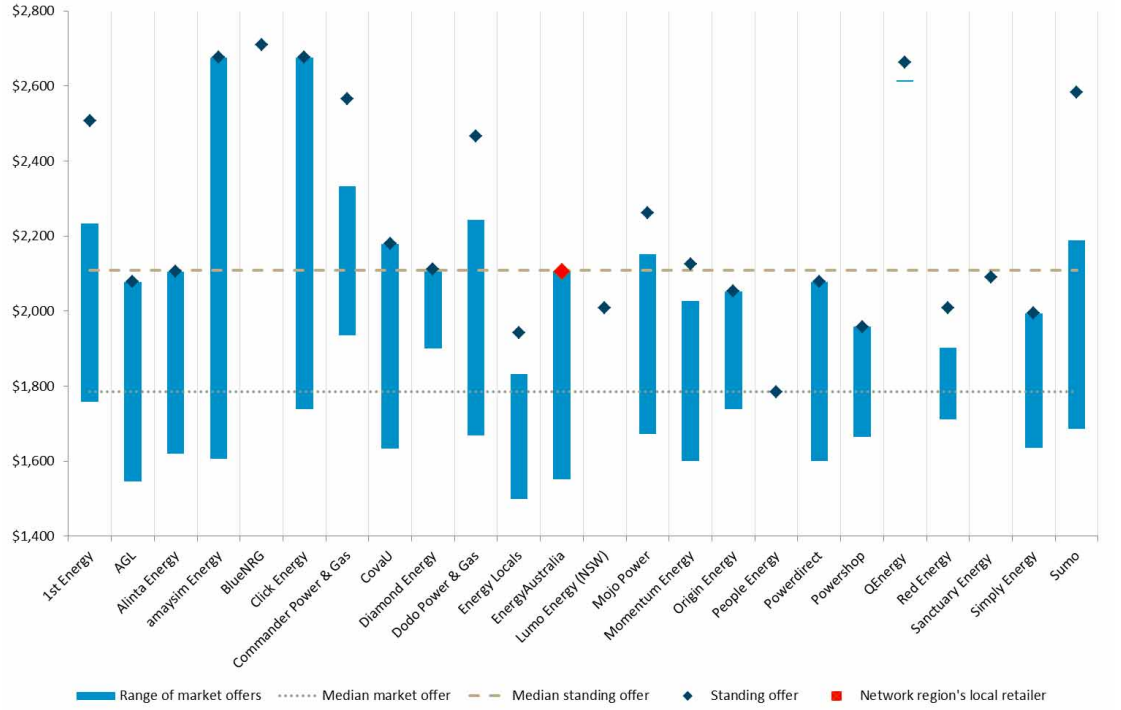
13 NERL, s. 25(1).
14 NERL, s. 25(3).
15 The designated retailer is also referred to as the local retailer.

2.2.1 Residential offers

The AER proposed in its *Default Market Offer Price Position Paper* that a default offer would be set for residential flat rate offers, residential flat rate with controlled load offers and small business flat rate offers.[16] Figure 2.1 to Figure 2.5 below show the spread of market and standing residential flat rate offers as at October 2018, using the AER's assumed consumption levels for each relevant network region. The median standing and market offer provides an indication of the range in which the AER's is likely to set the default offer.[17] This forms the basis of our analysis in Chapter 3.

Of note in the below figures, is that the local retailer in each distribution zone is likely to have the highest proportion of standing offer customers, and in each zone has a standing offer that sits at or below the median standing offer.

Figure 2.1: Spread of residential annual electricity bills from single rate offers - Ausgrid

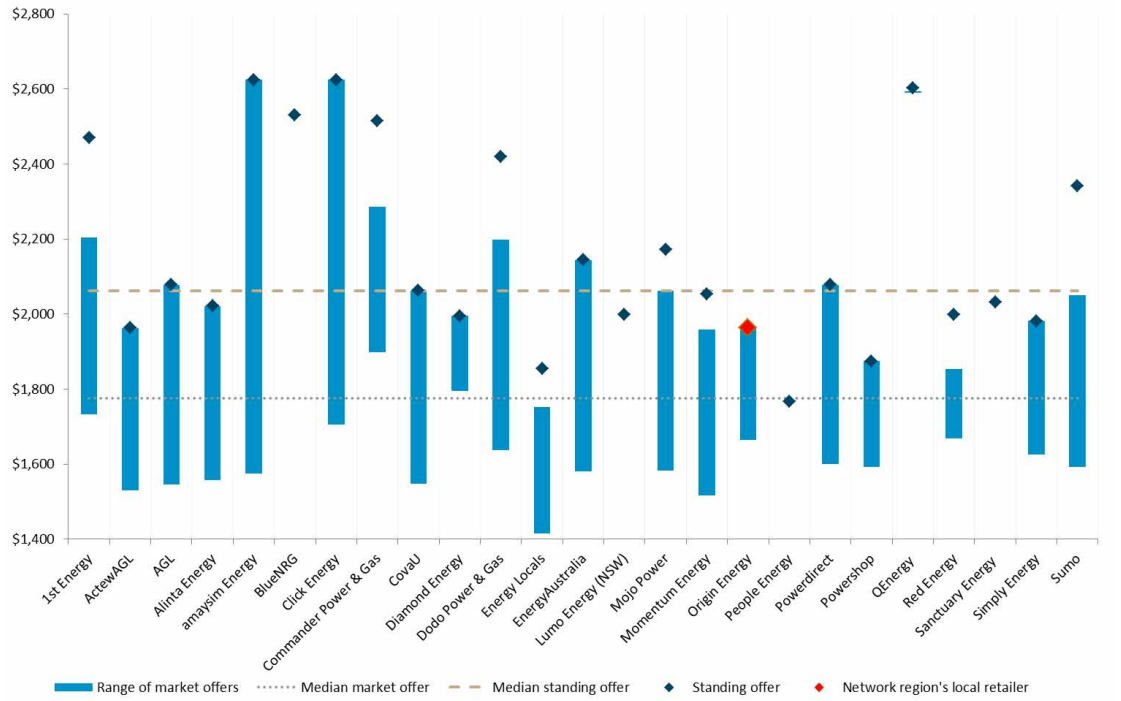


Source: EnergyMadeEasy, AEMC analysis.

16 AER, *Default Market Offer Price Position Paper,* 9 November 2018, pp. 10-11.

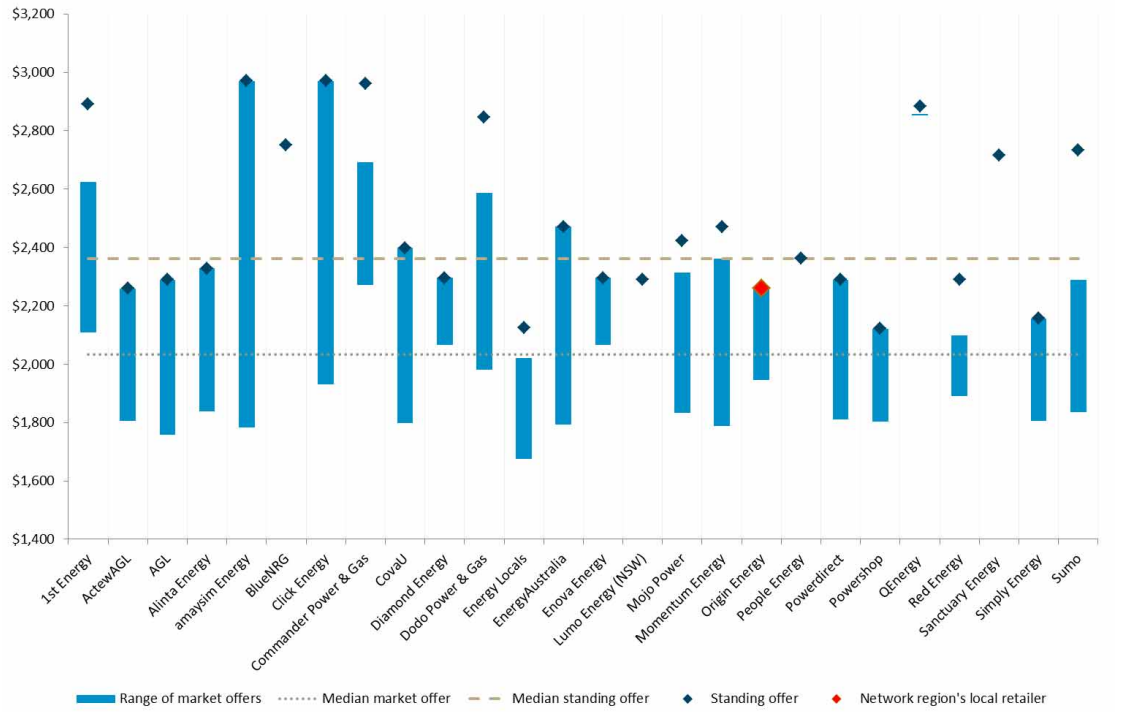
17 ibid. p. 17.

Figure 2.2: Spread of residential annual electricity bills from single rate offers - Endeavour Energy



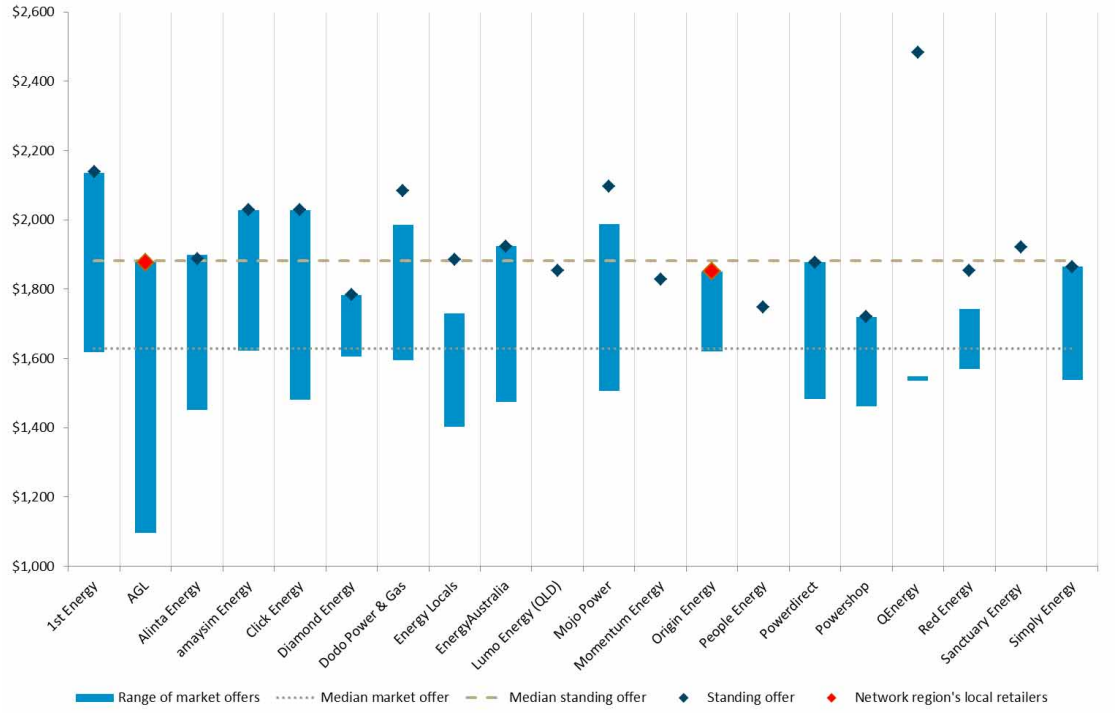
Source: EnergyMadeEasy, AEMC analysis.

Figure 2.3: Spread of residential annual electricity bills from single rate offers - Essential Energy



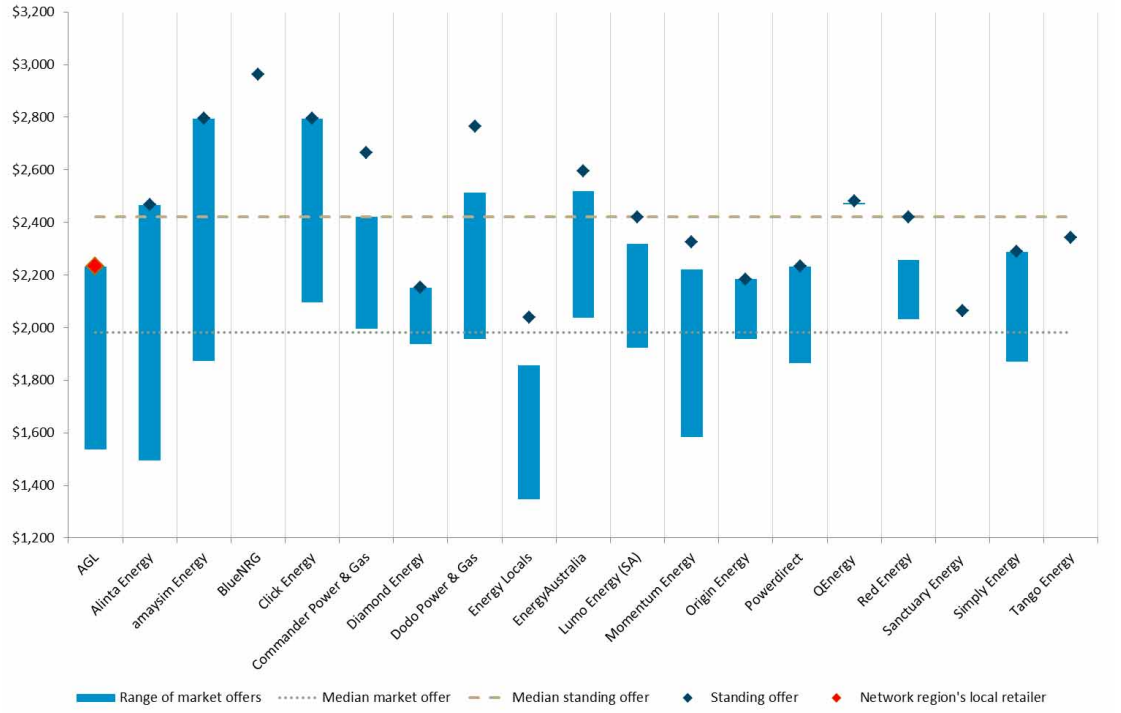
Source: EnergyMadeEasy, AEMC analysis.

Figure 2.4: Spread of residential annual electricity bills from single rate offers - Energex



Source: EnergyMadeEasy, AEMC analysis.

Figure 2.5: Spread of residential annual electricity bills from single rate offers - SAPN



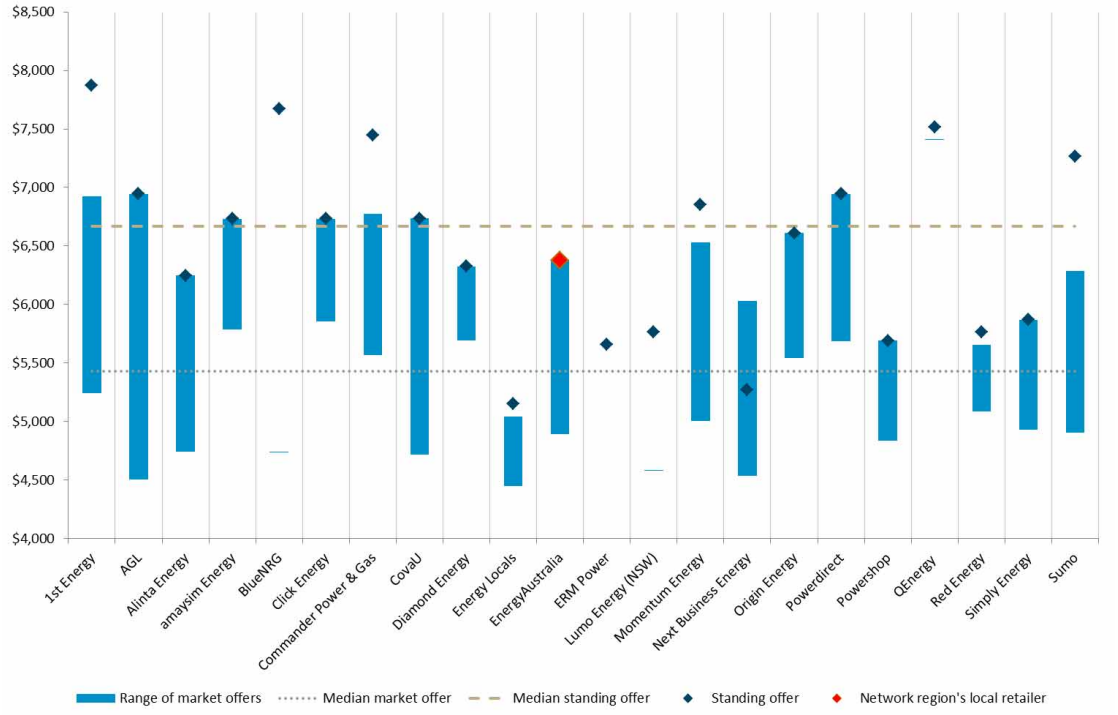
Source: EnergyMadeEasy, AEMC analysis.

2.2.2 Small business offers

AEMC analysis found a similar trend in the dispersion of annual bills of small businesses. This is despite the annual bill and the size of the dispersion being higher due to the greater consumption level assumed by the AER. Figure 2.6 below shows the level of annual bills and the spread of small business market offers based on flat rate offers for the Ausgrid distribution zone. This is indicative of the bills and spread of offers in each of the relevant distribution zones in the NEM, which are shown in Appendix B.[18]

18 That is the Essential Energy, Endeavour Energy, Energex and SA Power Networks distribution zones.

Figure 2.6: Spread of small business annual electricity bills from single rate offers - Ausgrid



Source: EnergyMadeEasy, AEMC analysis.

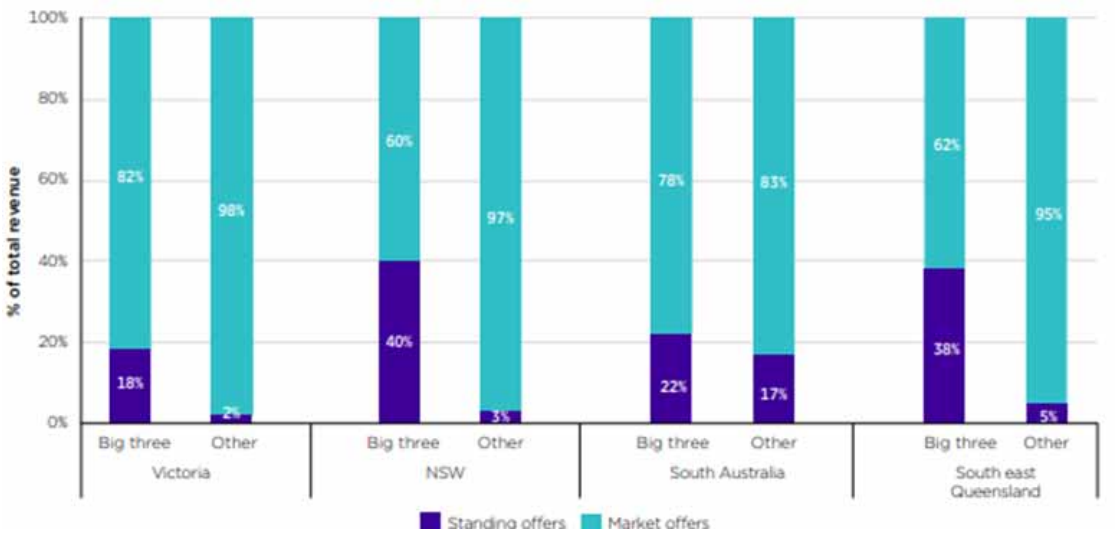
2.2.3 Source of retailer revenue

As part of its *Retail Energy Pricing Inquiry*, the ACCC analysed the source of retailer revenues and determined that average revenue for standing offer consumers is higher than average revenue for market offer consumers.[19] However, it also found that the majority of retailers' revenue is from market offer consumers, as shown in Figure 2.7 below.[20] The Commission notes that the reduction in the proportion of customers on standing offers (displayed in Figure 1.8) since the publication of the ACCC analysis is likely to have driven further decreases in the proportion of revenue earned from standing offers.

19 ACCC, *Retail Energy Pricing Inquiry - Final Report*, July 2018, ACCC, Canberra, p. 242.

20 ibid.

Figure 2.7: Standing and market offer revenue from residential customers by retailer type 2016-17



Source: ACCC *Retail Energy Pricing Inquiry - Final Report*, June 2018 p. 242.

2.3 How many customers are on standing and market offers

At the Commission's request, seven retailers provided a detailed breakdown of the standing and market offer customers they service in New South Wales, South East Queensland and South Australia.[21] The data provided represents 92 per cent of the customer base of these jurisdictions and was provided at a postcode level, split into residential and small business customers. This section analyses this data to provide a view on the number of customers on standing and market offers.

2.3.1 Residential customers

As shown in Figure 2.8 below, the proportion of customers on standing offers has progressively been decreasing over time in all four jurisdictions where prices are deregulated.[22]

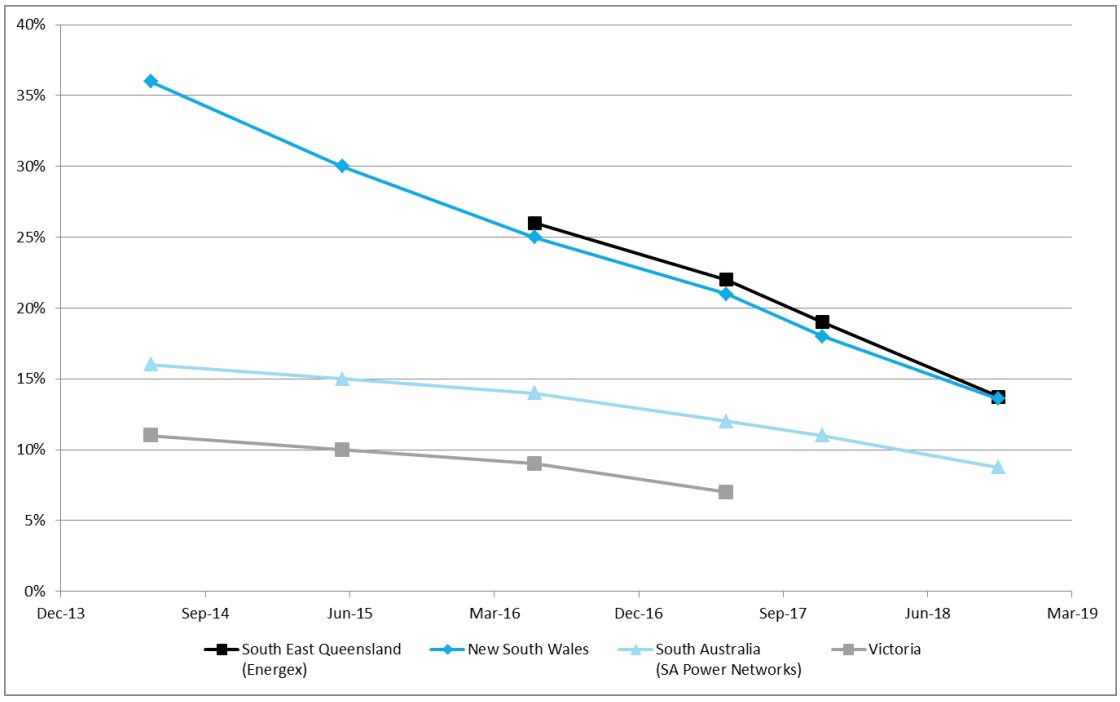
As can be seen in Figure 2.8, Victoria, which has had price deregulation the longest, has the lowest proportion of customers on standing offers. The remaining three jurisdictions are trending downwards, with all three jurisdictions expected to have less than 10 per cent of customers on standing offers within the next two years. As noted in the AEMC's *2018 Retail Energy Competition Review*, jurisdictions with full retail contestability, but regulated prices, have a much higher proportion of customers remaining on standing offers. In the Australian

21 This data was provided as at October or November 2018 depending on the retailer's systems.

22 Victoria was the first state to deregulate electricity prices in January 2009, followed by South Australia in January 2013, New South Wales in July 2014 and South East Queensland in July 2016.

Capital Territory, 70 per cent of customers remain on standing offers, and in Tasmania, 90 per cent of customers are on standing offers.[23]

Figure 2.8: Residential customers on standing offers, by jurisdiction



Source: ACCC *Retail Electricity Pricing Inquiry - Final Report*, June 2018, Figure 12.4 for data points from June 2014 to December 2017 and AEMC analysis of data provided by retailers for the data point on November 2018.

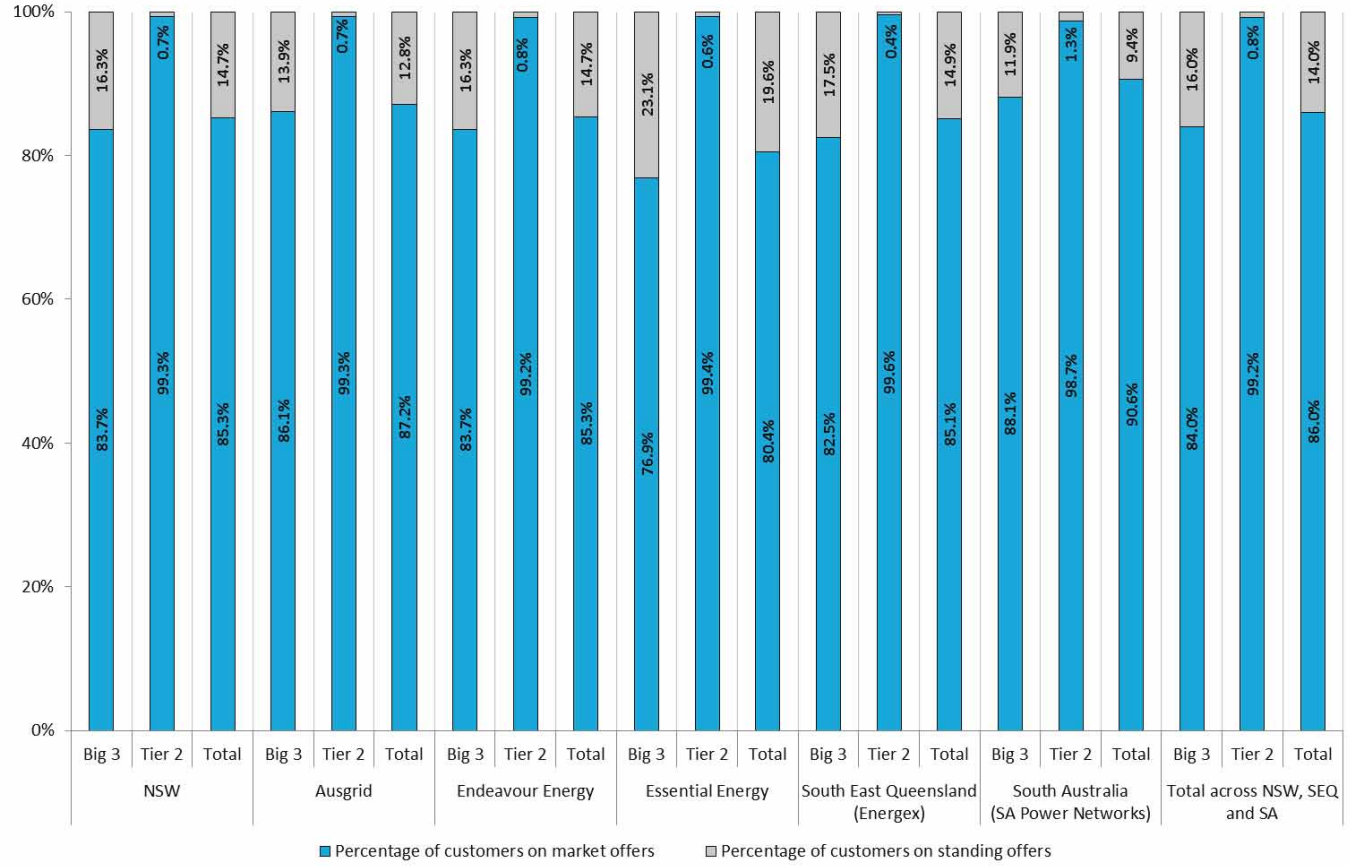
Note: The data point for November 2018 has been normalised to account for the 8 per cent of customers not captured in the data provided by retailers to the AEMC. Victorian customer numbers by offer type is released annually by the ESC and therefore is only available until June 2017.

Figure 2.9 below, based on data provided by retailers, shows that a majority of the customers of Tier 2 retailers are on market offers across all jurisdictions, ranging from 99.6 per cent in South East Queensland, and 98.7 per cent in South Australia.[24] Tier 2 retailers are likely to have a very small proportion of customers on standing offers as their customers are more likely to be active and engaged in the market.

23 AEMC, *2018 Retail Energy Competition Review - Final Report*, June 2018, AEMC, Sydney, p. 50.

24 In this Report the 'Big 3' retailers are AGL, Origin Energy and EnergyAustralia and the Commission refers to all non-Big 3 retailers as 'Tier 2' retailers.

Figure 2.9: Proportion of residential customers on standing and market offers



Source: Data provided by retailers as at October/November 2018, AEMC analysis

Figure 2.9 above also shows that the Big 3 retailers have a larger portion of customers on standing offers, which ranges from between 11.9 per cent in South Australia and 23.1 per cent in the Essential Energy network region.

As noted earlier, the local retailer in each jurisdiction has the highest proportion of customers on standing offers. Analysis of retailer data shows that on average in each network area:

- 22 per cent of the local retailer's customers are on standing offers
- three per cent of other retailers' customers are on standing offers, which includes the other Big 3 retailers who are not the local retailer in each area.

This is likely to be due to a proportion of customers who have never engaged in the competitive market and have not switched retailers since the customer base was sold to the local retailer when retail contestability was introduced.[25]

However, there is also a proportion of these standing offers who are 'move in customers' who have not contacted a retailer when they move house or a new premise is created. The local retailer often becomes the default provider and those customers remain on standing offers until they make contact with a retailer so a billing arrangement can be established.

2.3.2 Small business

Due to the diverse nature of small businesses in terms of size, turnover and energy intensity it is difficult to compare business customer experiences to residential customers. However, businesses have faced higher price rises and have higher consumption on average, than residential consumers. Their energy costs have risen materially in the past year. As detailed below, many small businesses, regardless of whether they have small or medium-sized energy loads, are still experiencing challenges in engaging with the market.

The AEMC analysed the data provided by retailers on their current small business customer offers. This analysis found that there is a higher proportion of small business customers on standing offers than for residential customers. The analysis also showed that the proportion of small business customers on standing offers ranges from:

- two per cent in South East Queensland and three per cent in the Endeavour Energy network region for Tier 2 retailers
- 19 per cent in South Australia and 32 per cent in South East Queensland for the Big 3.

The local retailer in each jurisdiction has between 20 per cent to 76 per cent of their small business customers on standing offers.

The level of customers on standing offers in each jurisdiction correlates to the length of time since price deregulation. The South Australian market, which has had price deregulation the longest of the three jurisdictions, has the lowest proportion of small business customers on standing offers. South East Queensland has the highest proportion and has had price

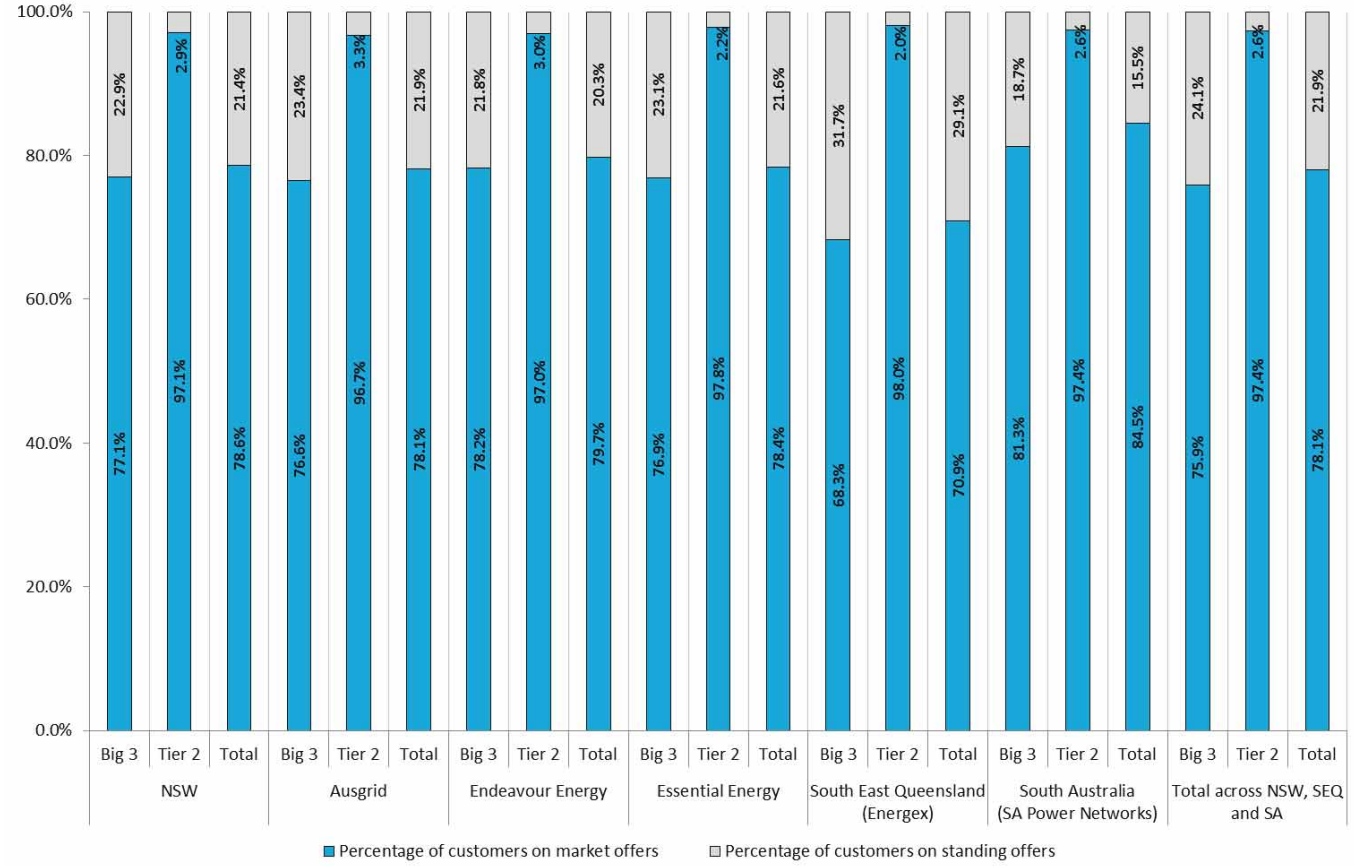
25 An exception to this is that in South East Queensland, when the market was opened up to retail contestability customers were sold to both AGL and Origin.

deregulation for the shortest period of the three states being investigated. This can be seen in the Figure 2.10 below.

The AEMC's *2018 Retail Energy Competition Review* found that small businesses were less likely to engage in the electricity market as result of being time poor.[26] In a survey of small business carried out as part of the 2018 review, most respondents stated that rather than search for better energy offers or take action to reduce their bill, they absorbed the recent price increases.[27] The survey also found that one in five small business owners were not confident in finding the right information required to switch retailers and/or plans.[28] Further, one in three small business owners found it difficult to compare the options once they had the information. However, the results also suggested that small business would be more likely to switch if their retailer contacted them in the right way.[29]

26 AEMC, *2018 Retail Energy Competition Review, Final Report*, 15 June 2018, Sydney, p. 124.
27 ibid, p. 118.
28 ibid.
29 ibid, p. 123.

Figure 2.10: Proportion of small business customers on standing and market offers



Source: Data provided by retailers as at October/November 2018, AEMC analysis

2.4 Characteristics of customers on standing offers

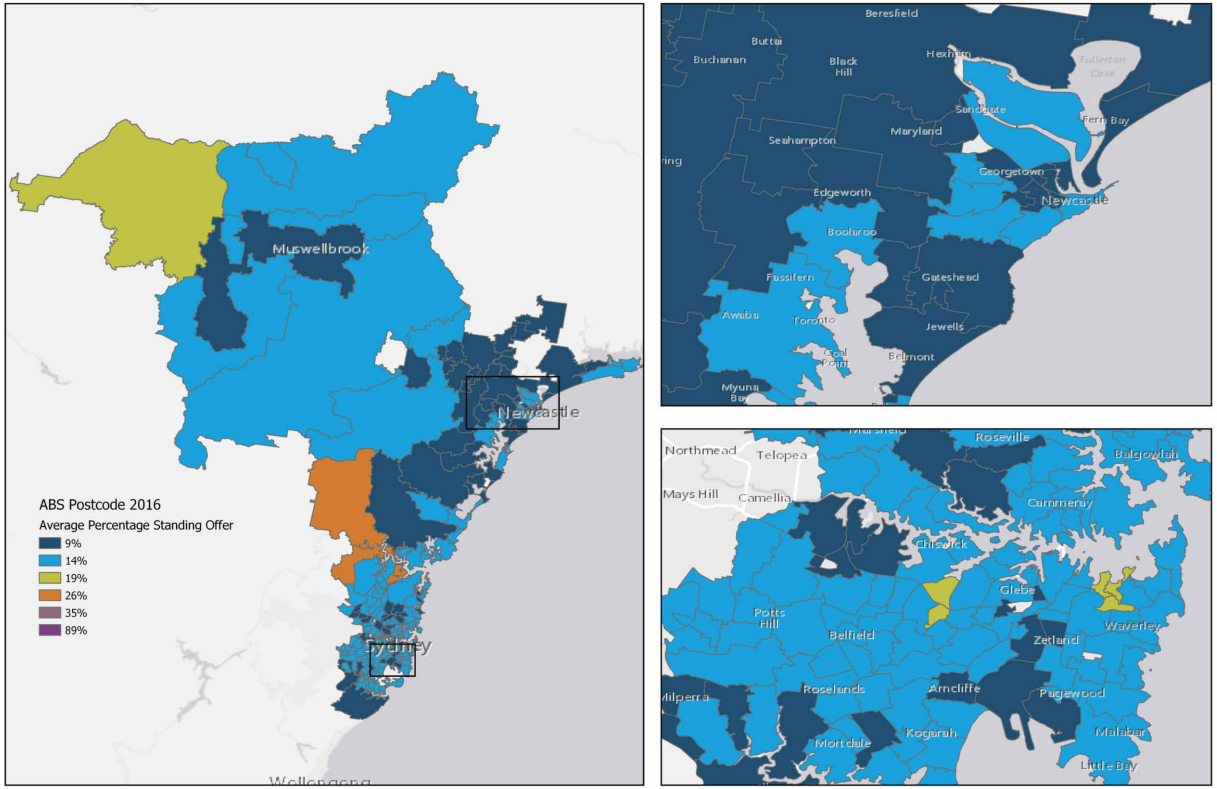
From the data provided by retailers, the AEMC was able to map the percentage of small customers on standing offers by postcode. Further analysis and an explanation of the methodology used is provided in Appendix C.

2.4.1 Residential customers

The postcode maps shown in Figure 2.11 to 2.15 show the proportion of customers in each postcode on standing offers. Those areas shaded blue represent areas with a lower proportion of customers on standing offers. Areas shaded orange and purple have a higher proportion of customers on standing offer. These figures show that:

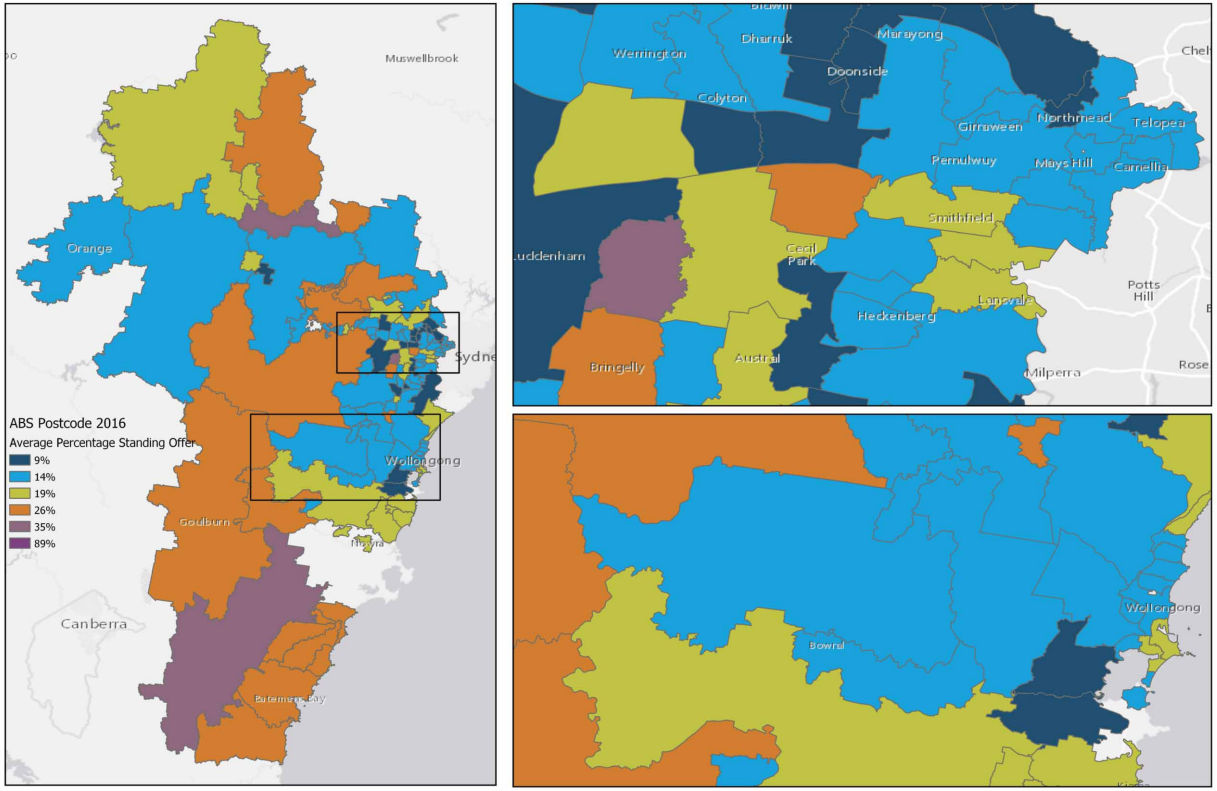
- There is a higher proportion of customers in regional areas on standing offers than in urban and metropolitan area in all network regions. Although rural areas represent a smaller number of customers than urban areas as reflected in the notes of each graph below. In New South Wales approximately 50 per cent of customers live in the Ausgrid area.
- The average percentage of customers on standing offers is lower in the Ausgrid and SA Power Network regions than in the Endeavour Energy, Essential Energy and Energex network regions.
- The postcode areas which include cities and towns are generally in the lowest groups of average percentage of customers on standing offers.
- The postcode areas which are regional and are some distance from a city or town generally have the highest proportion of customers on standing offers.

Figure 2.11: Residential customers on standing offers - Ausgrid



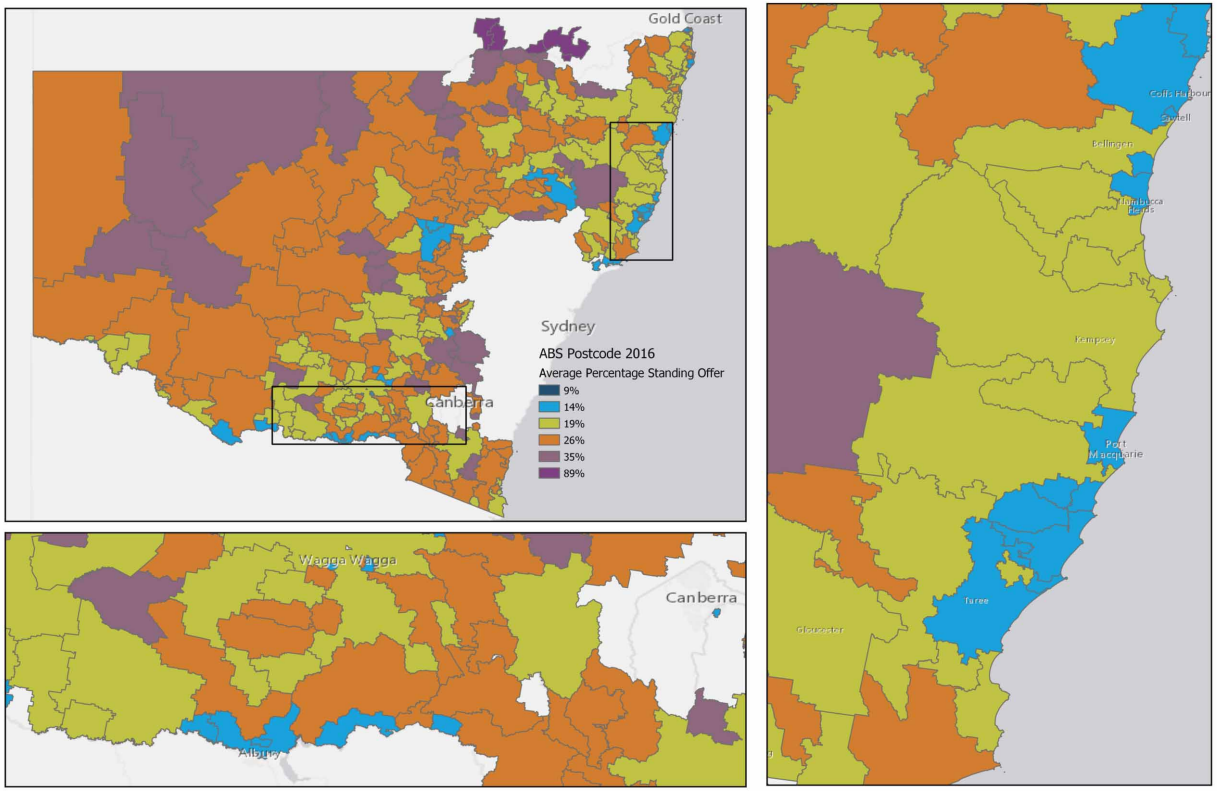
Source: AEMC analysis of data provided by retailers, ABS, Openstreet Maps
Note: 50 per cent of the customers of in New South Wales live in Ausgrid network region and is the most populous network region in state with 1,451,630 customers included in this analysis.

Figure 2.12: Residential customers on standing offers - Endeavour Energy



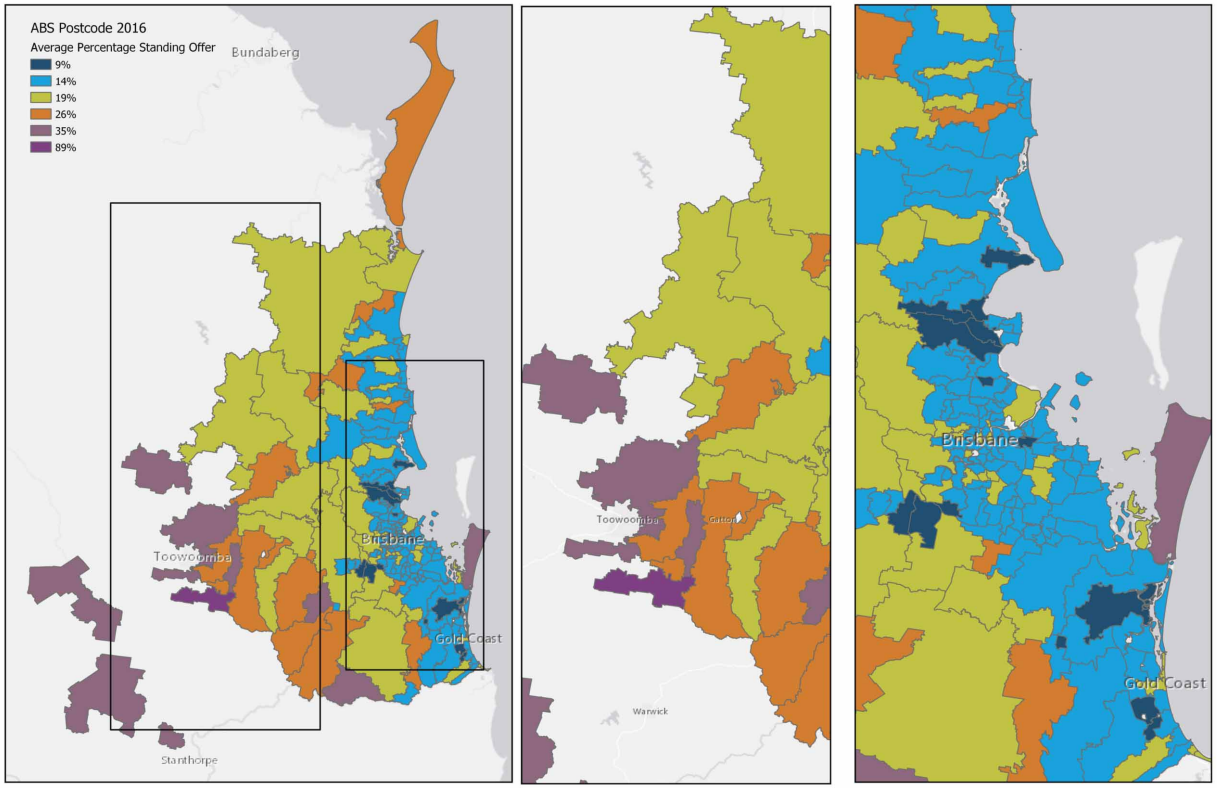
Source: AEMC analysis of data provided by retailers, ABS, Openstreet Maps
Note: 30 per cent of the customers in New South Wales live in the Endeavour Energy network region with 884,363 customers included in this analysis.

Figure 2.13: Residential customers on standing offers - Essential Energy



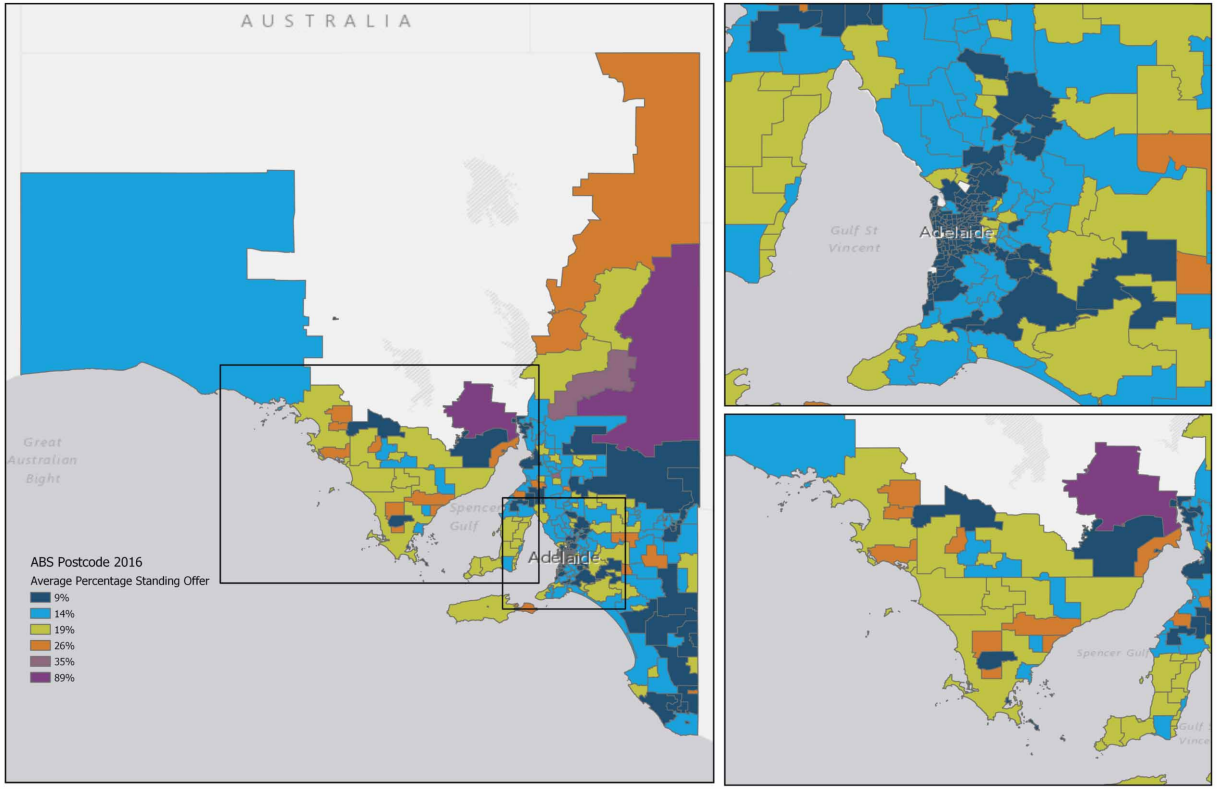
Source: AEMC analysis of data provided by retailers, ABS, Openstreet Maps
Note: 20 per cent of the customers of in New South Wales live in Essential Energy network region and is the least populous network region in the state with 580,475 customers included in this analysis.

Figure 2.14: Residential customers on standing offers - Energex (South East Queensland)



Source: AEMC analysis of data provided by retailers, ABS, Openstreet Maps
Note: 1,232,689 customers were included in this analysis of South East Queensland's electricity retail market.

Figure 2.15: Residential customers on standing offers - SA Power Network



Source: AEMC analysis of data provided by retailers, ABS, Openstreet Maps
Note: 727,774 customers were included in this analysis of South Australia's electricity retail market.

The AEMC also used the Australian Bureau of Statistics (ABS) *2016 Census of Population and Housing* data combined with the data provided by retailers to gain further insight into the characteristics of customers on standing offers. This analysis uses a model which predicts the percentage of standing offer customers for each postcode using socio-economic and demographic variables. It should be noted that this analysis does not result in a causal relationship between factors to any one customer being on a standing offer. Rather, it identifies correlations between socio-economic and demographic characteristics of customers within the postcode.

The analysis shows there is an increasing relationship between a postcode having a higher proportion of standing offers if the customers:

- have a lower proficiency in English
- occupy a property rent-free (such as being a home-owner)
- are 50 to 59 years old
- have the property as an unoccupied private dwelling.

The results also found that the following factors have a decreasing relationship between a postcode having standing offer customers if they:

- have a high proficiency in English
- are a renter
- are between 20 to 29, and 70 to 79 years old.

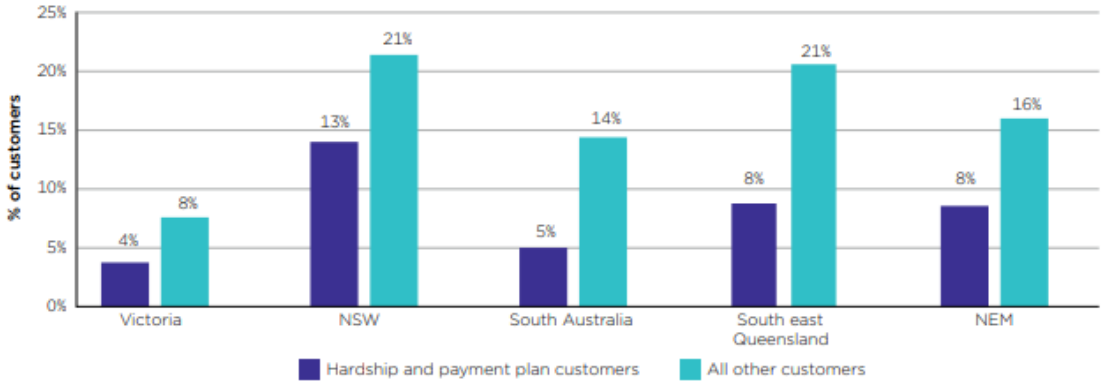
ACCC analysis of characteristics

Information gathered by the ACCC on the characteristics of customers on standing offer characteristics shows that:[30]

- Customers on hardship programs or payment plans are less likely to be on standing offers than other consumers, as seen in Figure 2.16 below. The ACCC is of the view that these consumers have a greater incentive to find better offers.
- Nine per cent of households with an income of less than $25,000 per year and eight per cent of households with an income higher than $75,000 are on standing offers. This is higher than the average of seven per cent.
- Consumers aged between 18 and 24, 30 and 34, and 75 and over are less likely to be on a standing offer than the average of seven per cent.

30 ACCC, *Retail Energy Pricing Inquiry - Final Report,* June 2018, ACCC, Canberra, pp. 244-246.

Figure 2.16: ACCC's analysis of hardship and payment plant customers on standing offers



Source: ACCC analysis based on retailer data.

Source: ACCC, *Retail Electricity Pricing Inquiry - Final Report* ,p. 245.

2.5 Recent changes to standing offers

Over the past 12 to 18 months there have been a number of initiatives aimed at assisting customers on standing offers.

2.5.1 Government initiatives

In August 2017, the Australian Government secured agreement from the biggest electricity retailers to write to customers on standing offers to notify them that there may be a better market offer available.[31] The Government was concerned that many consumers were not engaged in the energy market and not aware they could lower their bills by changing their energy retailer or plan. In March 2018, the Australian Financial Review report that this intervention resulted in 180,000 customers moving off standing offers.[32]

In November 2017, the Victorian Government obtained the agreement of three large retailers to provide a rebate to some customers (including concession holders) on standing offers equivalent to market offers rates for one to two years.

2.5.2 Retailer initiatives

A number of retailers have been working to encourage their customers on standing offers move to market offers or provide a benefit to those customers who are not engaging with the market.

31 See Prime Minister Press Release, 'Turnbull Government secures a better deal for Australia families', 30 August 2017, Available at:www.pm.gov.au/media/turnbull-government-secures-better-power-deal-australian-families.

32 Frydenberg J, 'Australia's energy market is on the rebound', *Australian Financial Review*, 6 March 2018 accessed 26 November 2018, <www.afr.com/opinion/columnists/australias-energy-market-is-on-the-rebound-20180306-h0x36i>.

AGL

AGL has been providing its customers who have been on a standing offer for more than two years with an automatic rebate. In November 2018, it announced that it was extending this rebate to those customers who have been on a standing offer for more than 12 months. These unconditional rebates will apply off supply and usage charges from 1 January 2019 for both residential and small business customers and range between five and 10 per cent. AGL reports that this will save their standing offer residential customers on an average between $50 to $180 per year, and between $120 to $340 for small business standing offer customers.[33]

EnergyAustralia

For 2018, EnergyAustralia provided its standing offer customers on hardship programs with a rebate on usage reflecting EnergyAustralia's best market offer in each jurisdiction. This applies to both electricity and gas. Recipients are reviewed every 6 months to ensure they receive the best market discount.

Further, from 1 January 2019, EnergyAustralia will provide its concession customers on standing or default offers in all jurisdictions with a 15 per cent discount against their usage for electricity and gas. EnergyAustralia reports that standing offer concession customers will save on average $270 a year on their electricity usage and $145 on gas.[34]

Red Energy and Lumo Energy

In November 2018, Snowy Hydro announced that, from 1 January 2019, standing offer customers of its Red Energy and Lumo Energy retailer brands will receive an automatic 10 per cent discount. It reports that this will save these customers on average between $195 and $270 per year.[35]

Origin Energy

From 1 January 2019, Origin Energy will provide a 10 per cent automatic discount on electricity usage to concession card holders in New South Wales, the Australian Capital Territory, Queensland and South Australia who are on standing offers or non-discounted plans. Origin Energy reports that from this, 230,000 concession card holders will receive, on average, a savings of $169 per year.[36]

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33 AGL, 'AGL announces safety net for electricity customers', media release, 16 November 2018, found at https://www.agl.com.au/about-agl/media-centre/asx-and-media-releases/2018/november/agl-announces-safety-net-for-electricity-customers.

34 EnergyAustralia, 'EneryAustralia concession customers to receive automatic discounts', media release, 27 November 2018, found at https://www.energyaustralia.com.au/about-us/media/news/energyaustralia-concession-customers-receive-automatic-discounts.

35 Snowy Hydro, 'Snowy Hydro's retailer give unconditional discounts to their standing offer customers', media release, 30 November, found at http://www.snowyhydro.com.au/news/shl_standing_offer/

36 Origin Energy, 'Origin to lower energy prices for concession customers', 30 November 2018, media release, found at https://www.originenergy.com.au/about/investors-media/media-centre/origin_to_lower_energy_prices_for_concession_customers.html.

Other retailers

The AEMC understands a number of other retailers are considering the ways they can further assist standing offer customers. This goes some way to mitigating concerns that standing offers involve a 'loyalty tax', but raises the risk of a default offer inadvertently increasing prices.

3 SHORT-TERM RISKS OF A DEFAULT OFFER

This chapter outlines the way in which the market is likely to respond following the introduction of a default offer, including:

- price changes and how they will impact customers
- implementation issues.

In order to understand the likely market response from a default offer, the AEMC had regard to:

- the ACCC's *Retail Electricity Pricing Inquiry* on its view on retailer pricing strategies and margins
- the experiences in the United Kingdom (UK) following the announcement of a temporary price cap.

The Commission combined this analysis with the range of default offer price levels set out in the AER's proposed approach paper to model the likely response of the market to the default offer.

3.1 Price changes and customer impacts

This section will outline potential retailer responses from a default offer, based on ACCC's analysis of retailer pricing strategies and margins, and the UK experience.

3.1.1 Potential retailer response

Based on the ACCC's market analysis, there are a number of pricing strategies retailers may take following the introduction of a default offer.

ACCC analysis of retailer pricing strategies

In its *Retail Electricity Pricing Inquiry,* the ACCC notes that retailers "deploy significant resources to segment existing and potential customers into different categories, identify high value customers amongst these categories, and target them with attractive offers".[37] The ACCC also outlines a number of ways in which retailers compete for valuable customers through their market segmentation. These include:[38]

- For "inactive or 'loyal' customers, retailers appear willing to intentionally increase their prices and use the customer's loyalty against them".
- Retailers develop specific products to appeal to different types of customers.
- Some retailers will intentionally increase prices paid by lower value customers with the intention of turning them into higher value customers or prompting them to move to another retailer.

Further, the ACCC argues that increasing the ability of customers to compare prices, while reducing cross subsidies between customers on the lowest and highest offers, may result in

37 ACCC, *Retail Energy Pricing Inquiry - Final Report*, June 2018, ACCC, p. 143.
38 ibid p. 144.

some of the lowest offers in the market today being no longer accessible.[39] From this, "consumers who seek out those [lowest] offers may end up paying more for electricity".[40]

This ACCC analysis highlights that retailers have sophisticated marketing and segmentation strategies in place to be able to manage the impacts of a default offer by potentially withdrawing offers for less valuable customer segments, and adjusting market offers for valuable and engaged customers over time.

ACCC analysis of retail margins

The ACCC also analysed retailer margins in its *Retail Electricity Pricing Inquiry.* In its Final Report the ACCC made no finding that it considered retail margins are inefficient or that retailers are earning excessive profits.[41] It noted that:[42]

- Tier 2 retailers are earning smaller margins that the Big 3, and it is the larger Tier 2 retailers who are the biggest threat to the Big 3
- retailers with smaller customer numbers have greater variability in their revenues and electricity demand which increases their energy and financial risk
- signs of a competitive market are present with a proliferation of offers, high levels of churn and extensive marketing.

This suggests that retailers are operating in a workably competitive market and that retailers are unlikely fully absorb a margin squeeze between costs and regulated retail prices.

Impact on standing and market offers

Risk to lower priced market offers

Based on the above, there is a risk that lower priced offers will be withdrawn from the market, to the detriment of active or price responsive consumers. These lower price offers are generally set at or below cost for the purpose of gaining market share. However, with the introduction of the default offer limiting the opportunity to recover the acquisition cost from offers in the future, retailers are likely to be less willing to make such offers. This will have particularly adverse effects on those customers that most actively seek out and value the best offers in the market.

In the ACCC's view, customers may switch away should their retailer respond by withdrawing lower priced offers from the market. However, as offers are likely to be withdrawn across all retailers, customers will have fewer incentives to switch retailers because the savings from switching will be reduced (as discussed further in Chapter 4). Further, through their segmentation information, retailers may be able to increase prices for loyal 'sticky' customers without those customer switching away. The outcomes of this is a risk that a large portion of customers could be worse off under the default offer.

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39 ibid.

40 ibid.

41 ACCC, *Retail Electricity Pricing Inquiry - Final Report*, June 2018, ACCC, chapters 6 and 10.

42 ibid, p. 136, 145 and 147.

Risk if increases to lower priced standing offers

Should the default offer be set between the median of standing and market offers as suggested by the ACCC[43] and AER[44], there is a risk that those standing offers below the default offer will be increased up to the capped amount. For example, as shown in Figure 2.5, in South Australia, AGL, as the local retailer, has a standing offer that is set well below the median standing offers.

There is a risk that retailers with lower default offers will be able to advertise a higher discount, potentially to the detriment of customers who pay a higher underlying rate (particularly if the discounts are conditional and the customer fails to meet those conditions).

Chapter 4 provides further information on the long-term retailer responses under a default offer, and the way in which consumers are likely to respond.

3.1.2 United Kingdom experience

The United Kingdom's (UK) experience in introducing a temporary default offer cap also provides insight into how the Australian market may respond.

Context for a default tariff cap

In June 2014, the Gas and Electricity Market Authority (GEMA) in the UK directed the Competition and Markets Authority (CMA) to investigate competition issues connected with the energy market in Great Britain. In 2016, the CMA concluded that the retail market was not working well for consumers on default tariffs.[45] The CMA found that customers on the default tariff engage less with the market, are less able to protect their interests and pay substantially higher prices. One of the remedies proposed to solve this was to introduce a price cap for all standard variable tariff (SVT or default fixed tariff [46]).

The majority of the CMA's panel concluded that the disadvantages of attempting to address the detriment of consumers on SVTs through price control could potentially result in worse outcomes for customers in the long-term. The panel considered that the risks of re-regulating outweighed the benefits through a combination of reducing the incentives of customers to engage, reducing the incentives of suppliers to compete and an increase in regulatory risk.

Professor Martin Cave dissented from this view. Professor Cave considered that a broader cap was required to address the short-term issue.[47]

Following the release of the report the UK Government adopted Professor Cave's position and introduced the *Domestic Gas and Electricity (Tariff Cap) Act* (the Act). The Act required GEMA to design a temporary, absolute cap on the price of SVT by the end of the 2018. On 6 November 2018, the Office of Gas and Electricity Markets (Ofgem) published its final decision on the design and implementation of the default tariff cap.

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43 ACCC, *Retail Electricity Pricing Inquiry - Final Report*, June 2018, p. 249.

44 AER, *Default market offer - Position Paper,* November 2018, pp. 22.

45 Competition and Markets Authority, *Energy Market Investigation: Summary of Final Report,* 24 June 2016, pg. 38.

46 These are equivalent to the concept of a standing offer in the NEM.

47 ibid p. 656; p. 1415.

Ofgem's approach

Ofgem's approach was to set the default tariff cap as a maximum price, not as a maximum bill.[48] For an individual customer, the amount they will pay under the cap varies depending on customers' consumption level, payment method, location and meter type. For each component of a customer's bill, Ofgem set an allowance based on the cost it is expected for a hypothetical efficient supplier to incur.[49] Ofgem has included wholesale, network, policy (environmental and social obligation), operating (including the cost of the smart meter) and standard credit costs, and a profit allowance at 1.9 per cent before interest and tax. These efficient allowances were estimated individually to derive the overall level of the cap. The default tariff cap also includes a headroom allowance, and was set higher than the estimated efficient benchmark.[50] Ofgem will update the default tariff cap every six months, with each cost component updated separately to deal with issues associated with volatility and uncertainty.

In August 2020, Ofgem will carry out a review to assess whether the conditions for effective competition are sufficient for the government to remove the cap.

Outcomes from introducing a default cap

Following the announcement of a default tariff cap in June 2016, there was an increase in the lowest tariffs offered by the six large suppliers (the Big Six) and other suppliers.[51] The Big Six increased prices for their cheapest offers much more than other retailers (27.7 per cent against 15 per cent of other suppliers from 2016 to 2017). Further, their average cheapest tariff was close to the market's average cheapest tariff before June 2016. Afterwards the difference started to increase. The difference between the average cheapest tariff and the average SVTs tariff for the Big Six narrowed (see Figure 3.1 and point B in Figure 3.2 below).

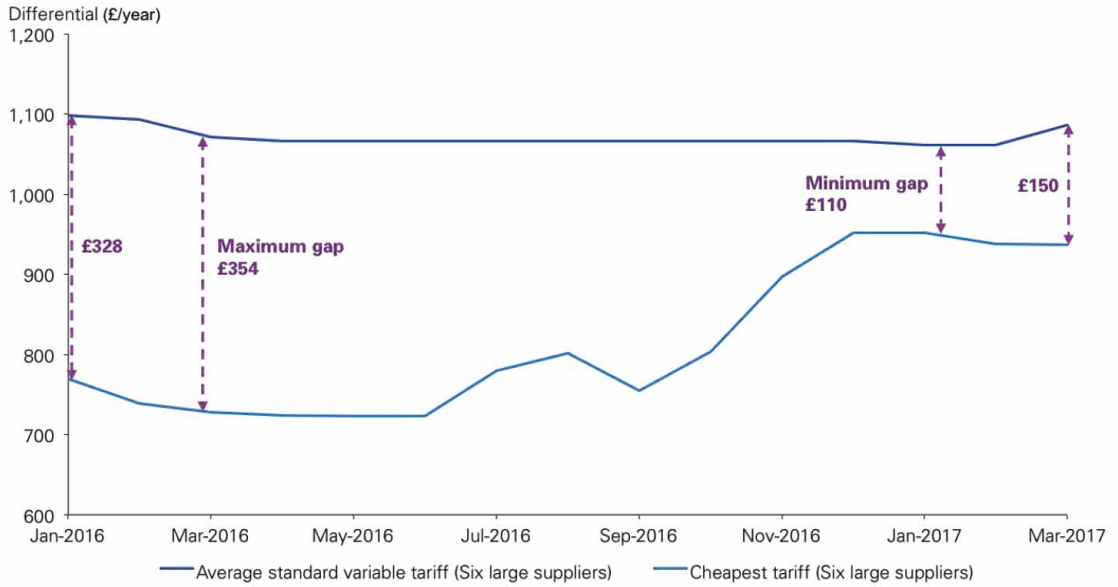
48 The cap level will not depend on a customer's energy supplier. The cap level is in annualised terms, Ofgem used Typical Domestic Consumption values (TDCV) and national average network charges. In the first cap period the cap level will be £1,137 for a typical default tariff customer – a dual fuel single rate customer paying by direct debit using a typical amount of energy in annualised terms.

49 https://www.ofgem.gov.uk/system/files/docs/2018/11/decision_-_default_tariff_cap_-_overview_document.pdf

50 The headroom was set at 1.46 per cent of the other cost components excluding network costs.

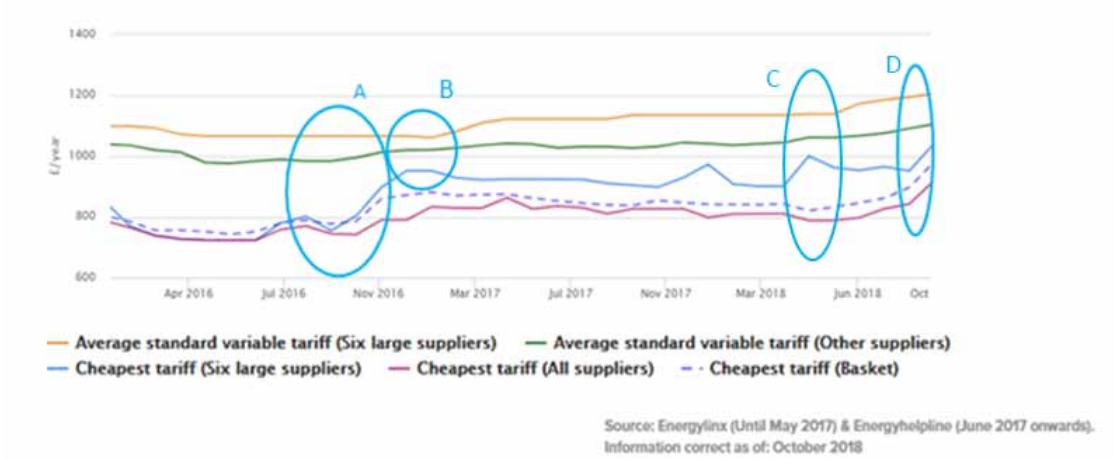
51 Ofgem retail statistics, found at https://www.ofgem.gov.uk/data-portal/retail-market-indicators.

Figure 3.1: 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.

Figure 3.2: Retail UK price comparison by company and tariff type-Domestic



Source: Ofgem https://www.ofgem.gov.uk/data-portal/retail-market-indicators.

In February 2018, before the Domestic Gas and Electricity (Tariff Cap) bill was introduced, prices were starting to stabilise. However, two months later, there was a second period of increases, specifically, in the Big Six's lowest tariffs (see point C, Figure 3.2 above).

In October 2018 Ofgem reported that prices across the whole market have been increasing. For instance, in September 2018, the average cheapest tariffs for the whole market increased

again (see point D, Figure 3.2 above). Some retailers have announced another price rise for customers on both SVTs and default fixed tariffs which took effect on October 2018 and will be captured in the coming months.

Table 3.1 below summarises the price responses in the UK following various decisions regarding the temporary default cap.

Table 3.1: Summary of UK price responses

	JUNE 2016 - CMA REPORT RELEASED	FEBRUARY 2018 - DOMESTIC GAS AND ELECTRICITY (TARIFF CAP) BILL INTRODUCED	SEPTEMBER 2018
Big Six response	The average price for the cheapest market tariffs increase by 27.7 per cent (comparing June 2016 to 2017)	The average price for the cheapest market tariff increase by 11 per cent from February to April 2018	The average price for the cheapest market tariffs increase by 15 per cent (compared to 2017) The average price for the cheapest market tariffs increase by 40 per cent (compared to 2016)
Other retailers response	The average price for the cheapest tariffs increase by about 15 per cent (comparing June 2016 to 2017)		The average price for the cheapest tariffs increased by 11 per cent (compared to 2017)
Whole of market			The average price for the cheapest market tariffs increased by 18 per cent (compared to 2017)

Source: Ofgem https://www.ofgem.gov.uk/data-portal/retail-market-indicators

3.2 Modelling of potential impacts

The Commission has combined this analysis with the range of default offer price levels set out in the AER's proposed approach paper to model the likely response of the market to the default offer.

The AEMC modelled the analysis of the potential impacts, in terms of a representative customer bill. The representative customer usage for each jurisdiction is taken to be the consumption in the *AER's Default Market Offer Position Paper*.[52] The representative customer

52 AER, *Default market offer - Position Paper,* November 2018, pp. 22

standing offer is then calculated by multiplying consumption by the effective price (c/kWh) of the average standing offer from the ACCC *Retail Electricity Pricing Inquiry*.[53] A range of market offers in each jurisdiction is then calculated by applying the mid-point of the discount tier bands from the estimated standing offer.[54]

Following the introduction of the default market offer the assumption is that retailers will not set any offer above the default offer. While this is not an explicit part of the default offer, this is a likely outcome because:

- with a default offer implemented it would be difficult to assess market offers above this level
- the NERR and the Australian Consumer Law (ACL) prevent discounting off rates above standing offers and discounting is the primary means of marketing currently.

The objective of the model is to achieve the revenue target by progressively increasing the market offers from the cheapest offer up until the target is reached. If there are insufficient customers on the lowest tier of offers then the offer for the second cheapest tier will be raised in parallel, and so on until the revenue target is reached. The Commission recognises that there are a myriad pricing strategies retailers may take in response to a default offer as outlined above. However, the below analysis highlights potential risks associated with a default offer.

3.2.1 Retailer revenue recovery

A key assumption in the modelling is how retailers may respond to a decrease in revenue from standing offer and higher prices market offer customers following the introduction of a capped default offer. Based on the ACCC's analysis of retailer profitability and pricing behaviour, and international examples of the re-introducing price regulation outlined above, it is likely that retailers will respond to the introduction of the default offer by increasing market offers.

The extent to which this occurs is uncertain and the Commission has therefore modelled a range of scenarios. To provide the COAG Energy Council with a balanced view, the Commission has presented the results of a 50 per cent revenue recovery in this paper. That is, where retailers increase their market offers such that they recover half of the lost revenue from the introduction of the default offer. The assumption of 50 percent recovery is illustrative understates the likely magnitude of revenue recovery. Findings from both a 50 per cent and 100 per cent revenue recovery case are consistent with a greater compression of market offers.

3.2.2 Findings

Modelling shows the impact on the spread of market offers for New South Wales, South Australia and South East Queensland as outlined in the following sections.

53 ACCC, *Retail Electricity Pricing Inquiry - Final Report*, June 2018, Ch 1; pp. 12, 15, 18 & 21.

54 That is the offer representing the 5-10 per cent discount band will be 7.5 per cent less than the estimated standing offer. The > 30 per cent discount tier offer is set to 32.5 per cent less than the standing offer.

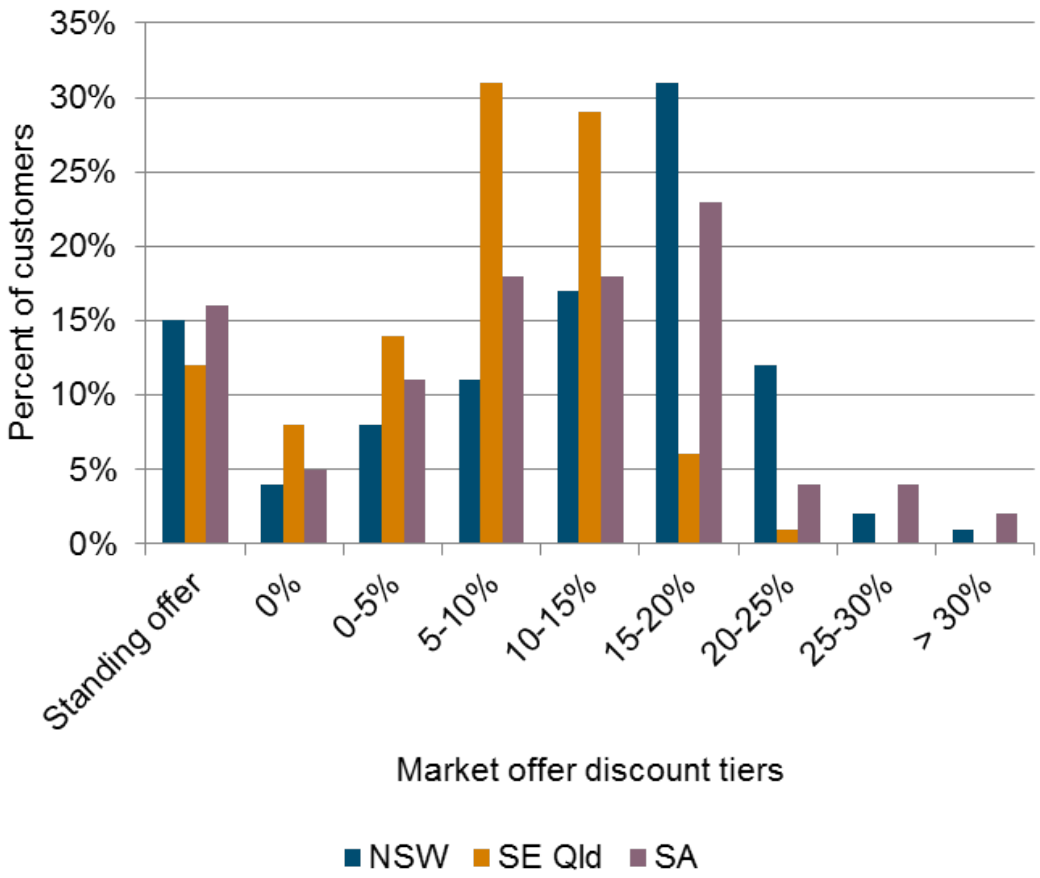
Spread of market offers

Figure 3.3 below shows the distribution of non-PV residential customers by discounting tier. In New South Wales, about 46 per cent of customers are on discounts of at least 15 per cent relative to the standing offer. The corresponding percentage in South Australia is approximately 33 per cent but with a greater proportion of customers on large discounts of 25 per cent or greater. By contrast, only around seven per cent of South East Queensland customers are on offers with discounts of 25 per cent or greater, and around 20 per cent of customers are on a standing offer or a market offer with zero per cent discounts.

The degree of compression in offers depends upon the proportion of customers on standing offers in each jurisdiction and the proportion of market offer customers with only small discounts. Jurisdictions with a larger proportion of customers on standing offers will see a greater compression of offers under a default offer as a larger revenue shortfall is spread across fewer customers on discounted offers.

In South Australia and New South Wales, there are a greater proportion of customers on larger discounts. Therefore, the revenue shortfall from a default offer will be smaller and the shortfall will be spread over a larger number of customers on the largest discounts.

Figure 3.3: Percentage of customers by market offer discount tier



Source: ACCC, *Retail Electricity Pricing Inquiry - Final Report*, June 2018.

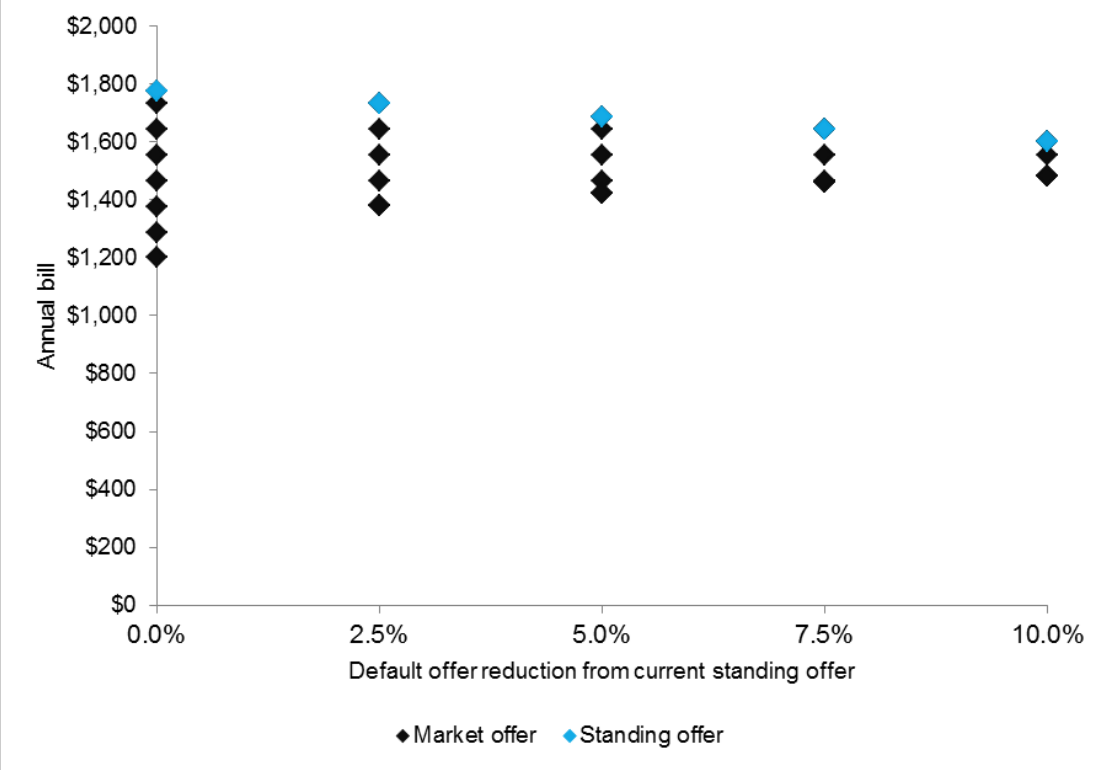
New South Wales

Figure 3.4 shows the results of our modelling for New South Wales. It shows the distribution of offers without a binding default offer (zero per cent on the horizontal axis), and for a default offer set at five per cent or 10 per cent below the current average standing offer.

The results of the modelling, as shown in Figure 3.4 below, are that the spread of offers available to consumers is greatly reduced under a binding default offer. Assuming a rate of 50 per cent revenue recovery, the figure shows that a default offer set 10 per cent below the current average standing offer will result in a 23.6 per cent increase in the lowest market offer bills.[55]

55 The assumption of partial revenue recovery reduced the required increase in the market offers. For instance, if we assume full cost recovery the same default offer results in a 28.1 per cent increase in the lowest market offer.

Figure 3.4: Range of offers under default offer (New South Wales, 50 per cent recovery)

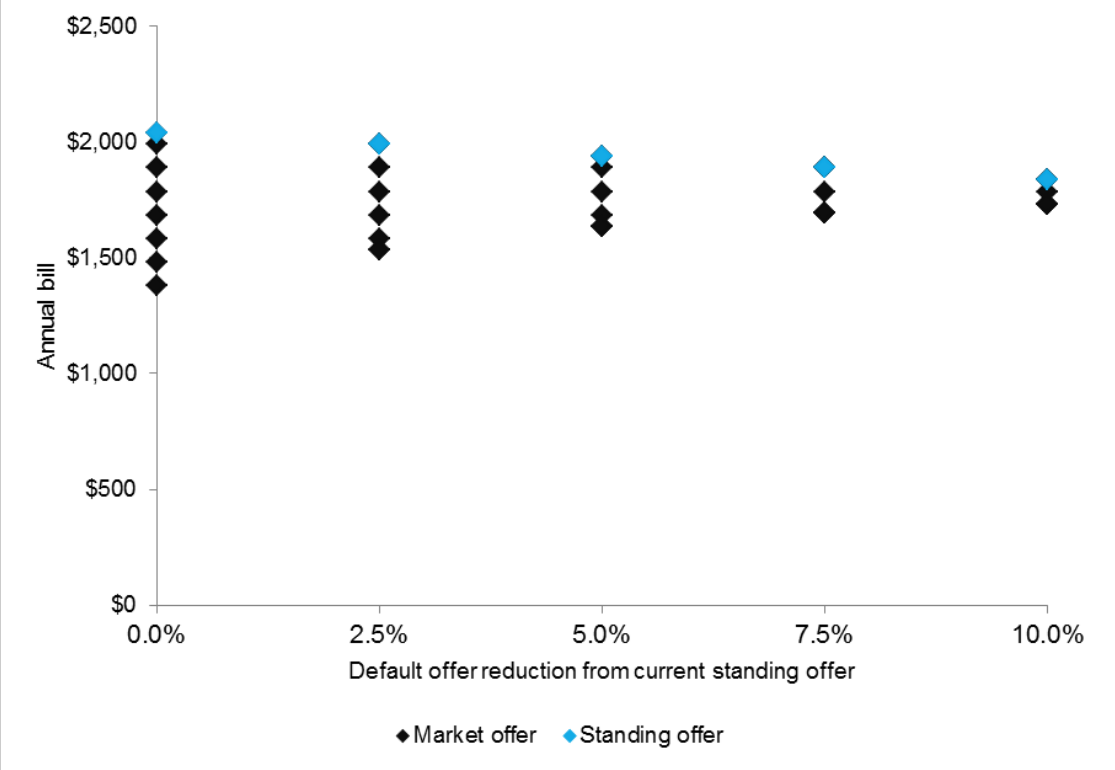


Source: AEMC analysis

South Australia

In South Australia we observe a similar reduction in the spread of market offers under a default offer. Figure 3.5 shows the corresponding distribution for South Australia. A default offer set 10 per cent below the current standing offer price increases the lowest market offers by 25.8 per cent.

Figure 3.5: Range of offers under default offer (South Australia, 50 per cent recovery)

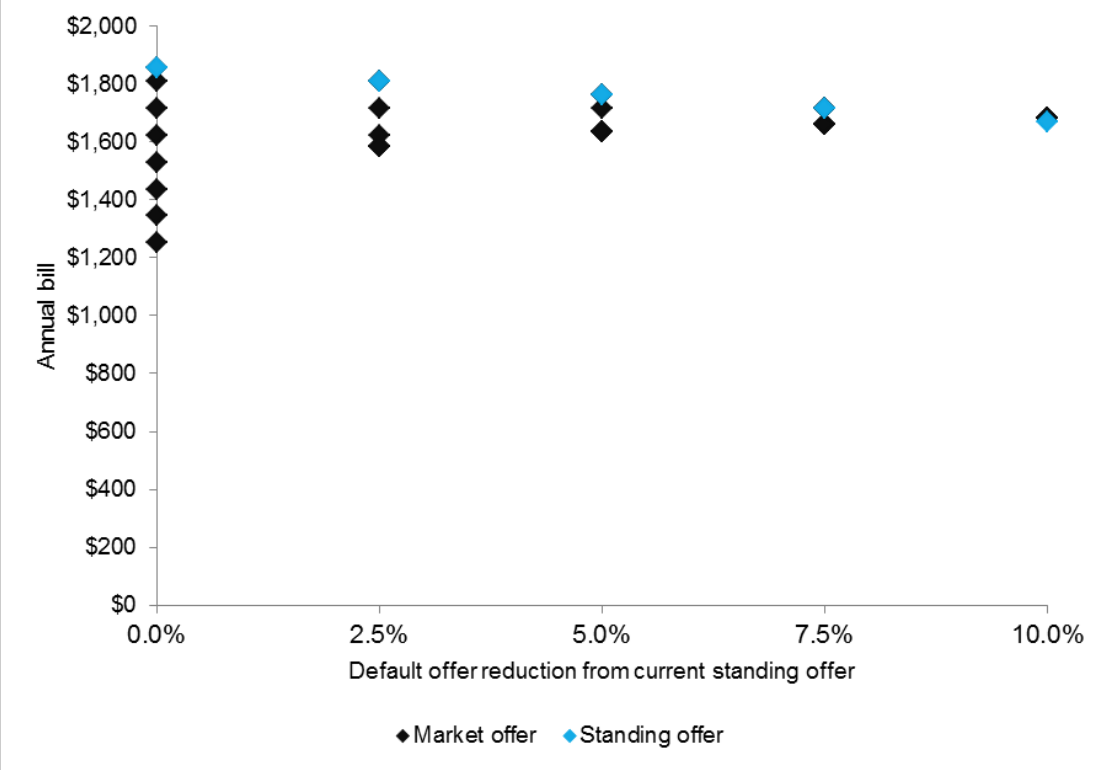


Source: AEMC analysis

South East Queensland

The compression of offers for a given reduction from standing offers is much greater in South East Queensland. Figure 3.6 shows the corresponding distribution for South Australia. Again, assuming a rate of 50 per cent revenue recovery, a default offer set five per cent below the current standing offer results in a 30.8 per cent increase in the lowest market offer bills. However, as can be seen in Figure 3.6 below, if the level of the default offer is set at 10 per cent below the current average standing offer, the only way for retailers to recover 50 per cent of their revenue shortfall is to set market offers above the default offer. This will have implications for the level the default offer can be set without having significant impacts on retailers' viability in Queensland.

Figure 3.6: Range of offers under default offer (South East Queensland 50 per cent recovery)



Source: AEMC analysis

3.2.3 Outcomes

Across all three jurisdictions, there is a risk that even small reductions in the default offer below current average standing offers results in a larger response from retailers among lower market offers.

Comparing the range of offers under these scenarios, the size of the increase in market offer bills depends on:

- **How low the default offer is set** — a lower default offer increases the revenue shortfall that needs to be recovered from market offer customers.
- **How many customers are on discounted market offers** — fewer market offer customers results in higher market offers, as the revenue shortfall is spread across a smaller number of customers. This means the impact will be greater in markets where deregulation has occurred more recently.
- **The level of revenue recovery assumed** — greater recovery of the revenue shortfall necessitates higher market offer prices.

Based on the modelling and international experience, there is a risk that the introduction of a default offer will result in an increase in lower priced market offers. Should retailers adjust

prices to recover their existing level of revenue, there could be a greater impact on the level of market offers as highlighted above. Under either scenario, the introduction of the default offer will create winners and losers:

- customers on standing offers and market offers above the default offer will likely be better off
- some customers on lower standing offers could potentially be worse off
- customers on lower priced market offers are likely to be worse off.

As outlined in Chapter 2, across New South Wales, South East Queensland and South Australia there is a significantly higher proportion of customers on market offers compared to standing offers (86 per cent compared to 14 per cent respectively). This results in a larger portion of the market who may be worse off under the default offer than those who will benefit. Consumers who have engaged actively in the market and are on the lowest market offers may likely see those offers withdrawn or phased out, and so will lose some of the competitive benefits they now enjoy.

There is a cohort of consumers who will be better off under a default offer, which as discussed in Chapter 2, include rural customers and small businesses. Chapter 5 provides a potential alternative to the default offer that could reduce some of the risks outlined in this chapter, while also benefiting customers who are still on standing offers.

3.3 Implementation issues

The short timeframe for the introduction of the default offer may lead to a number of implementation issues relating to current market contracts with consumers, which may result in unintended consequences.

3.3.1 Impact on current market offers

Retail market offers tend to be structured in one of the following ways:

- discounts off the retailer's standing offer[56]
- discounts off a market rate (which may be equivalent to the retailer's standing offer)[57]
- a flat rate with no discounting applied[58]
- other more innovative structures like Mojo Energy's subscription tariffs or Origin Energy's predictable plan.

In implementing the move to a new capped default offer, retailers may (depending on the terms and conditions of the relevant retail market contract) respond by:

- Varying the base rate for their existing market contracts to ensure no loss of revenue — this may lead to market offer customers paying a higher price depending on their usage patterns and the conditions of the discount.

56 For example, Alinta Energy's discounts are based on Alinta's published standing tariffs with a 24 month benefit period (Source: Energy Made Easy at www.energymadeeasy.gov.au)

57 For example Origin Energy and EnergyAustralia (Source: ibid)

58 For example Momentum Energy (Source: ibid)

- Varying the discount rate to ensure no loss of revenue from the default offer (if lower) —- while this may not increase the final bill of a consumer, it is likely to lead to confusion and mistrust.
- Maintaining the existing discount to the default offer and lose revenue — some retailers may have no options but to lose revenue, and for smaller retailers, this margin squeeze may lead to them exiting the market (risks relating to market exit are discussed further in Chapter 4).

For example, an existing customer on a market offer with say a 20 per cent discount off their retailer's standing offer who is paying an average price of say 28c/kWh. Given the terms of the contracts, if the retailer's standing offer was reduced by 10 per cent, the reduction would flow through to the market offer contract price. If the retailer wished to keep the customer at the same 28c/kWh price level, they would need to convince the customer that while their discount had reduced, their price was the same. To the extent this proved difficult it might add further pressure for the retailer to withdraw its lower priced market offers from the market.

Further, each of the potential responses by retailers is likely to result in a range of impacts, including customer confusion as retailers contact each customer to explain the potential changes in their contracts. From 30 April 2019, when the AER announces the final default offer, retailers will need to determine the impacts on revenue, their response and then contact customers to explain any changes.

A particular concern noted by retailers in discussions with the Commission is those contracts which have a fixed discount percentage off a standing offer locked in beyond 1 July 2019. For example, a retailer may have provided customers with a market offer that is a twenty per cent discount off their standing offer rate for two years. Retailers with such contracts are likely to either need to renegotiate these contracts or effectively face a regulated market offer price well below the default offer price.

The AEMC's *2018 Retail Energy Competition Review* found that consumer trust in the energy market has dropped and many customers are responding by becoming disengaged.[59] In this context, the Commission considers that the impact of a default offer without transitional arrangements is likely to result in further customer confusion and mistrust.

When the Commission makes rules that potentially require changes to participants and customers contractual arrangements, the industry and stakeholders usually support a transitional period to ensure they are able to roll out changes in an orderly way with minimal confusion for consumers, and make the necessary system changes required.

3.3.2 Timing of the introduction of a default offer

The length of time provided to the AER to develop the default offer represents a potential implementation risk. Table 3.1 below outlines the timeframe for IPART's 2013 price reset and the timing the AER will be required to follow for the default offer.

59 AEMC, *2018 Retail Energy Competition Review - Final Report*, June 2018, pp. vii - viii.

While the timing seems generally aligned there are a number of factors that result in a higher risk for the AER in carrying out the process in the same timeframe as IPART:

1. In undertaking price regulation in 2013, IPART had long established systems, processes and methodologies in place for price regulation because it had been carrying out this function for many years.
2. IPART was setting prices within one jurisdiction (New South Wales). The AER is required to set prices in three jurisdictions New South Wales, South East Queensland and South Australia which is a more complex task.
3. The AER will be undertaking the task at a time of greater industry change and wholesale market volatility making forecasting components of the cost stack a more difficult task.
4. Because IPART was transitioning the New South Wales market to price deregulation businesses operating the market were familiar with price regulation. The AER is introducing the price cap to a number of businesses who may not have operated under price regulation, which imposes a number of risks.

Table 3.2: IPART and AER process for regulating prices

STEP	IPART	AER
1. Receive detailed Terms of Reference	September 2012	Letter of request provided October 2018
2. Release issues paper/position paper	November 2012	November 2018
3. Receive retailer pricing proposals	November 2012	N/A
4. Hold public forum on issues paper/position paper	December 2012	November 2018 to January 2019
5. Release draft determination	March 2013	February 2019
6. Public hearing on draft determination	April 2013	N/A
7. Final determination	May 2013	April 2019

Source: IPART and AER

Given the above, caution should be taken in relation to implementing the default offer in a short timeframe. This may suggest that a less risky approach would be for a comparison rate to be developed initially, with an option to move to a default offer in the longer term should it not result in improved outcomes for consumers. The comparison rate is discussed in Chapter 5.

4 LONG-TERM RISKS OF A DEFAULT OFFER

In addition to the price dispersion and implementation challenges that are likely to occur in the short-term, the Commission has analysed the longer term structural effects of the introduction of a default offer. These are presented in this chapter and are broken down into:

- risk
- innovation
- consumer responses.

4.1 Risk

The introduction of the default offer is likely to change the risks faced by electricity retailers.

Electricity retailers must raise funds for investment and operating purposes in highly competitive capital markets. These markets assess the risks associated with the nature of the businesses operations and feed this risk assessment into the price at which capital is made available.

Introducing a regulated price cap introduces uncertainty into assessment of the business's future financial performance and therefore increased risk for both equity and debt investors. Given efficient capital markets, this will lead to an increase in the cost of both equity and debt finance. In the long-term, higher industry costs of capital are likely to be passed through to customers through higher prices.

Higher risks to retail businesses are already starting to be observed in the market. For example, financial market analysts are now suggesting caution on investment for publicly listed retail companies. The Commission's discussions with industry and industry submissions to related reviews have also reflected these concerns. For example, in response to questions around the default offer in its submission to IPART's New South Wales retail market review, Origin considered that:[60]

> Pricing intervention undermines certainty and creates additional risk, which will only serve to exacerbate supply and price issues.

This impact is likely to be magnified for new entrant retailers and could act as a barrier to entry. New and smaller retailers tend to exhibit lower levels of vertical integration in generation and are therefore less likely to fully absorb a margin squeeze between costs and regulated prices. To expand their customer bases new entrant retailers also tend to be seeking new finance and therefore tend to be more exposed to market wide increases in financing costs.

60 Origin Energy, *Submission to IPART Draft Report: Review of the performance and competitiveness of the retail energy market in NSW*, October 2018, p. 4.

These issues regarding financing of new retailers have also started to be observed in the market. For example, in its submission to IPART's *Draft Report: Review of the performances and competitiveness of the retail energy market in NSW*, Sumo Power observed that:[61]

> As a new entrant retailer that relies on tapping into capital markets to fund its growth, the impact of price regulation will be felt well before the regulated price is ever determined. The threat of price regulation makes investors nervous and may mean some retailers will be unable to raise the capital required to fund future growth.

The effects of increased risk faced by retailers may also have impacts on other parts of the supply chain. Box 1 below explains linkages between the wholesale and retail market and how increases in retail risks are likely to effect investment in new generation.

BOX 1: INTERACTION OF INCREASED RETAIL RISK WITH GENERATION INVESTMENT AND THE WHOLESALE MARKET

There is a strong inter-relationship between the wholesale energy market and contracts markets. In the short-term, retailers enter into hedging contracts and power purchasing agreements (PPA's) to the extent that such contracts minimise the risk adjusted forward cost of energy (through removing exposure to extreme price volatility). Similarly, generators have an incentive to hedge exposure to spot price volatility while using longer term contracting arrangements such as PPAs to underpin investment in new generation capacity.

In the long run, in the absence of price regulation, the expected price of hedging contracts and PPAs must be sufficient to support new investment in generation capacity. That is, must be equal to the long run incremental cost of efficient new entrant generation. However, increased risk to retailers through introduction of retail price regulation will disrupt this link by decreasing retailers ability to offer attractively priced hedging contracts and PPAs.

Where such contracts are not available, new generation investments will be harder to finance and less likely to occur. This will either put upward pressure on wholesale prices or drive a deterioration in reliability because installed capacity will no longer be sufficient to meet demand.

Source: AEMC analysis

4.2 Innovation

The default offer may also inhibit innovation in electricity retail markets, particularly price based innovation. The default offer will lock in the small number of regulated tariff structures as central to price setting and advertising in the retail market. For example, the AER in its proposed approach paper has flagged it is likely to set a default offer for two flat tariffs (one controlled load and one without) for residential customers and one flat tariff for small

61 Sumo Power, *Submission to IPART Draft Report: Review of the performance and competitiveness of the retail energy market in NSW,* October 2018, p.2.

business customers. This will make it more difficult for retailers to market other pricing structures and products to customers.

KPMG has drawn similar conclusions from observation of international retail markets. In particular, KPMG noted in it *Energy retail markets - An international review* that while passive customers may benefit, markets with price regulation tend to exhibit limited diversity in terms of new business models or new products and services.[62]

The introduction of a cap on prices is also likely to have an effect on retailers incentive to innovate. The development of innovative service offerings for retailers is dependent on the expected value of such offerings in the long term being positive. Often new service offerings will result in early losses that need to be recovered later as scale increases (assuming the service offering is attractive to customers). The presence of a default offer in effect provides a constraint on expected returns at a later date through capping what retailers can charge and earn in the future. The cap on expected future returns is therefore likely to reduce the number of such products and offers which are developed.

Similar to the issue of risks, the barriers to innovation created by the default offer are likely to have a larger effect on the viability of new than established retailers. Recent new entrants into the retail electricity space have often used a strategy of developing innovative services focused on residential and small customers to get a market foothold (for example, Energy Locals, Enova Power, Powershop, Mojo Energy and People Energy). An increase in the difficulty to market new tariffs, products and services is likely to increase barriers to entry in the market and reduce competition over time.

If the default tariff is set based on a flat rate, this also may disincentivise customers to move onto time of use tariffs, which may better enable them to manage their bills. This will impact on innovation, and could see the cost-effectiveness of the roll-out of smart meters reduced. It may also inhibit the take up of solar PV and batteries as time of use incentives for these products is important. The risk from these impacts is that the default offer is likely to further embed incumbency and market power.

4.3 Consumer Response

The introduction of a default offer is also likely to have consequences for how consumers behave in the market.

4.3.1 Switching behaviour

As set out in Chapter 2, following the introduction of retail contestability and price deregulation in Victoria, New South Wales, South Australia and South East Queensland, customers have increasingly moved from standing to market offers. Overall customer switching rates in jurisdictions with price deregulation have also been increasing.[63]

62 KPMG, *Energy retail markets - An international review*, April 2017, KPMG, Melbourne.

63 AEMC, *2018 Retail Energy Competition Review - Final Report*, June 2018, AEMC, Sydney p. xxi

However, as outlined in the AEMC's 2018 Review of Retail Competition, recent survey suggest that residential customers need to save around 20 per cent on their bills, and small businesses 20 to 26 per cent on their bills compared to their existing plan before they are likely to switch. As the level of price dispersion (analysed in Chapter 3) decreases in response to the default offer, so too will the ability of consumers to achieve the required savings to compel them to switching plans or retailers. Over time, this is likely to result in less customers actively shopping around in the market.

This outcome was noted by KPMG in its review of international retail markets for the Victorian government. Box 2 below outlines KPMG's analysis of what happened in the Ontario market following price re-regulation.

BOX 2: CASE STUDY: ONTARIO RETAIL MARKET

In its report to the Victorian government, KPMG outlined the market response in Ontario following the re-regulation of prices. In 2005, the Ontario Government took steps to stop the process that was under way to deregulate the market. This was done in response to volatility in the wholesale market caused by a tightening in supply and high demand. The Ontario Energy Board then reintroduced price regulation with a view to providing stable electricity prices.

In KPMG's analysis, while re-regulation reduced price volatility, the competitive market shrunk. Prior to the price freeze, 25 per cent of customers switched to a competitive provider, which reduced to just six per cent following re-regulation. KPMG also reported that innovation in the market is only happening to a limited extent where driven by the regulator, rather than by the competitive market. This is because there is "limited incentives to offer new products and services because of the downward pressure on the regulated rate on competitive prices, and as a consequence, few customers have an incentive to switch to a competitive provider".

Source: KPMG, *Energy retail markets - An international review*, April 2017, KPMG, Melbourne, pp. 8, 41-42 and 99.

A smaller proportion of the market that is engaged and active is likely to have a flow on effects to competition and innovation. In the long run, reduced competition and innovation is likely to flow through to customers again through higher prices and a smaller range of products and services.

Similar observations have been made by IPART in its Review of the performance and competitiveness of the retail energy market in New South Wales.[64] IPART noted that lower levels of customer engagement is also consistent with the experience of the jurisdictions (both in Australia and around the world) that have maintained government price controls.[65] IPART considered that with only the most price sensitive consumers engaged in the market, competition would be likely to decrease which in the long run would drive higher prices.[66]

64 IPART, *Review of the performance and competitiveness of the retail energy markets in NSW - From 1 July 2017 to 30 June 2018 - Draft Report*, October 2018, p. 76.

65 ibid.

66 ibid.

4.3.2 Increase in customers moving onto the default offer

A further consequence of the default offer is the direct effect that having a government set price in the market is likely to have on consumer behaviour. There is a risk that consumers will perceive the regulated default offer as a safer choice than a tariff set by a retailer. This may result in consumers moving from market offers to the default offer even when there is no intention for the default offer to be the best offer in the market.

KPMG made similar observations recently in assessing the potential introduction of price regulation in Victoria. KPMG raised particular concern about the effect of re-regulating a market that had previously been deregulated, noting that:[67]

> In Victoria, customers could also perceive the re-introduction of price regulation after 15 years of competition as a sign that retail energy markets do not work, eroding trust in the market. In turn, this may reduce customers' propensity to search out better deals. As mentioned above, a regulated tariff may also be viewed as being more predictable and a "safer" choice than a tariff set by a business.

The Commission in its recent retail energy competition reviews has noted a declining level of trust in retailers. Declining levels of trust will also increase the likelihood of consumers selecting the regulated default offer.

67 KPMG, *Energy retail markets: An international review,* April 2017, p.45.

5 CONCLUSION AND ALTERNATIVE OPTIONS TO THE DEFAULT OFFER

5.1 The problem to be solved

The ACCC proposed the introduction of a default offer as a means of addressing, what it considered to be the dual problems of:

1. unreasonably high standing offers being charged to disengaged customers
2. a lack of comparability of retail market offers.

5.1.1 Unreasonably high standing offers

Chapter 2 sets out information on the number of customers on standing offers. Notably, updated figures since the publication of the ACCCC report demonstrate that there is a strong trend of the number of small customers on standing offers decreasing. It is likely that New South Wales, South Australia and South East Queensland will have less than 10 per cent of residential customers on standing offers within the next two years. Further, there exists a segment of the market (approximately two to four per cent of all customers) who are on standing offers for a very short period when they move house or create a new connection and have not yet selected a market offer. Based on this analysis, the Commission considers there is not a structural problem with standing offers that needs to be solved.

More granular analysis of the make up of customers on standing offers reveals that there are specific groups of customers that are over-represented within the standing offer cohort. The Commission recommends that targeted actions should be undertaken to assist these groups in utilising the benefits of retail contestability. These groups include rural customers not located near a city or town, non-English speaking customers and small businesses. The Commission has previously carried out work for individual government to identity information channel for these specific cohorts that could be useful to assist them in accessing the benefits of retail markets.

5.1.2 Comparability of market offers

This then leaves the problem of the ability for small customers to compare offers. As noted in Chapters 3 and 4, the default offer is likely to result in risks in both the short and long term, including:

- high transaction costs to implement
- lower price dispersion and removal of low price offers from the market resulting in higher bills for price sensitive customers
- increased risks of operating in the retail market resulting in higher financing costs
- lower levels of competition and innovation.

Given these risks, caution should be exercised in introducing the default offer as a regulated cap. Rather, the Commission considers a specific solution to assist customers to compare market offers should be developed.

5.2 Alternate approach - Comparison rate

In order to address the discounts off what problem, and reduce customer confusion, the Commission considers that a comparison rate should be developed. Under a comparison rate, because retailers would be required to compare their standing and market offers to the comparison rate, the incentive to inflate standing offers to advertise large discounts in their market offers would be removed.

The Commission notes that there is potentially some confusion in the market with regard to what a reference price and a comparison rate are. When the Commission recommends a comparison rate it is referring to a simple metric (such as a yearly bill) for consumers that could be used to compare different offers on a like for like basis. In this way it would address the customer confusion issue and would not force a re-allocation of consumers to different pricing plans.

Comparison rates have been used in the banking sector since 2003, and provide a standardised way to compare the offers of different retailers.

Banking comparison rates are covered by the National Consumer Credit Protection Regulations (NCCP) 2010. These cover retail personal and home loans as well as credit cards. The comparison rate requires that the total cost of the loan, including interest rates, fees and charges and the cost of setting up a loan are combined into a single percentage rate to make comparisons between offers easier for consumers. The comparison rate is typically higher than the underlying interest rate. Comparison rates are required to be published alongside all advertisements that contain an interest rate. The regulations specify a number of designated contract values and terms which retailers must use to calculate the comparison rate.

5.3 Other initiatives to improve consumer outcomes

Over the past two years there has been at least 25 actions taken by the Commonwealth and jurisdictional governments, and market bodies with the aim to improve consumer experience in the retail energy market.

The AEMC's *2018 Retail Energy Competition Review* recommended the facilitation of actions to empower consumers, as the most important focus for industry action. In particular, the report identified the roll-out of smart meters, improved access to consumer usage data and improved comparison services.[68] These actions would empower consumers and undermine the predominant price discounting model that is used in the sector. It was noted that such actions were also being complemented by rule changes to address poor industry practices, such as:

- preventing discounting from inflated rates
- requirements to notify customers at the end of contract benefit periods
- requiring retailers to provide advance notice of price increases

68 The Review, made two recommendations to improve comparison services: Recommendation 3 – to establish an industry code of conduct for energy comparison sites; Recommendation 4 – for all comparison websites to clearly display the number of retailers and plans represented on their site.

- changes to retailer information disclosure requirements via the revised Retail Pricing Information Guidelines
- strengthening protections for customers in financial hardship.

Further to this the ACCC made a broader set of recommendations to address other problematic industry pricing practices. Additional suggestions included:

- Measures should be taken to accelerate the take-up of cost-reflective network pricing. To protect against bill shock, there should be a compulsory data sampling period for customers, a requirement for retailers to provide a flat rate tariff offer, and additional targeted protections for vulnerable consumers (Recommendation 14).
- Support steps for the take-up of smart meters (Recommendation 15).
- The application of the consumer data right to the electricity sector should be pursued as a priority (Recommendation 31).
- Conditional discounts must be related to the value of the activity (Recommendation 33).
- There should be a mandatory code of conduct for third party intermediaries offering comparison advice (Recommendation 34).
- The government should commit to ongoing funding of government-run comparator sites (Recommendation 36).
- COAG should improve concession schemes across the NEM to ensure that, to the extent possible, there is a uniform national approach to concessions (Recommendation 37).
- There should be a government grant scheme for community organisations to improve energy literacy (Recommendation 38).

5.4 Recommendation

Given the potential risks associated with the introduction of a default offer, and the range of initiatives under way to assist customers, the Commission considers that the default offer should be developed as a comparison rate or soft cap as a "do no harm" approach to solving the "discounts of what" issue.

As part of its 2019 retail energy competition review, the Commission will provide advice to the COAG Energy Council on how to design a comparison rate. This advice would be provided by March 2019 and would leverage off the design work on the default offer that the AER has and is continuing to carry out.

The Commission would also provide advice on actions to assist those sub-groups of customers (e.g. rural and small business customers) that have higher than average proportions remaining on standing offers.

In the short-term, these proposed solutions are likely to address the problems of unreasonably high standing offers and a lack of comparability between market offers. However, they would do so with fewer risks than introducing the default offer. If, after 12 months, the COAG Energy Council still sees issues with the standing offers, the default offer could be revisited, with the comparison rate serving as the basis for a default offer.

ABBREVIATIONS

ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
BSO	Basic service offer
CARC	Customer acquisition and retention costs
CMA	Competition and Markets Authority
COAG	Council of Australian Governments
Commission	See AEMC
GEMA	Gas and Electricity Markets Authority
IPART	Independent Pricing and Regulatory Tribunal
MCE	Ministerial Council on Energy
NCCP	National Consumer Credit Protection
NEM	National energy market
NEO	National electricity objective
NERL	National Energy Retail Law
NERR	National Energy Retail Rules
Ofgem	Office of Gas and Electricity Markets
PPA	Power purchase agreements
QCA	Queensland Competition Authority
ROLR	Retailer of last resort
SAPN	SA Power Networks
SCO	Senior Committee of Officials
UK	United Kingdom

A TERMS OF REFERENCE

Figure A.1: Tasking letter from SCO seeking advice on a default offer (page 1)

COAG Energy Council
Senior Committee of Officials

Mr John Pierce AO
Chair
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Mr Pierce,

On 26 October 2018, the COAG Energy Council considered the ACCC final report to its Retail Electricity Pricing Inquiry (REPI). At the meeting the Council agreed on the need to develop a reference price, and ask the AEMC to undertake analysis of the Commonwealth's proposed default tariff policy.

Consistent with this decision, I ask the AEMC to start preparing analysis on the impacts of the proposed default offer.

Considering the analysis will be on Australian Government policy I ask that the AEMC has regard to the below policy outline and assumptions, and liaise with the Commonwealth on policy design and implementation issues.

The analysis should consider the impacts of the default offer on competition and small consumers, including price for both standard and market offer customers across the NEM. The AEMC should consider which small consumers will benefit from a default tariff policy and which may be worse off. The competition analysis should include the impact on offerings of second tier retailers. The work should analyse the impact of the default offer on NEM states and territories (or parts of states) where the retail market is competitive and retail prices are deregulated.

In preparing this advice the AEMC should be mindful of the ACCC's analysis of retail margins and costs. This includes the ACCC's finding that not all retailers receive the same levels of revenue and that the major retailers are achieving margins well over the expected economic rates of return in a competitive market.

In light of this we ask that the AEMC analysis also has regard to the Australian Government's intention to adopt the ACCC's recommendation to improve retail price transparency and competition (recommendation 32 from the REPI report). For the purpose of this work the Commonwealth's default offer rate is understood to be:

- a price cap set by the AER for each network region where retail prices are deregulated;
- a price cap imposed on standing offers with a flat rate tariff structure and offered by all retailers authorised in competitive markets;

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Figure A.1: Tasking letter from SCO seeking advice on a default offer (page 2)

- based on the efficient cost of operating in each region, including a reasonable return on investment, as well as cost to serve customers, and customer acquisition and retention costs; and,
- to be applied by retailers in circumstances where a standing offer is set by the individual retailer and applied to small customers (residential and business customers). The analysis should not include customers of exempt sellers.

The AEMC's analysis should consider consumer and competitive impacts on retail markets in New South Wales, South Australia, and South East Queensland. The analysis should consider residential and small business consumers.

It is the Commonwealth's intent that the default offer is set at a level to ensure that competition remains effective and that the default rate is not so low that it would result in market offer products being crowded out of the market. Therefore we ask that the AEMC also has regard to the scope of retailers to provide competitively priced offers below the prescribed default rate.

In terms of timing I ask that the AEMC provide that advice to the COAG Energy Council by Friday, 7 December 2018. AEMC staff leading on the project are asked to contact Mr James O'Toole, Assistant Secretary of the Electricity Branch at James.O'Toole@environment.gov.au to discuss the project. The AEMC are also asked to liaise closely with officials in New South Wales, South Australia and Queensland on this work.

I look forward to receiving the advice.

Yours sincerely

Mr Rob Heferen
Chair of SCO
12 November 18

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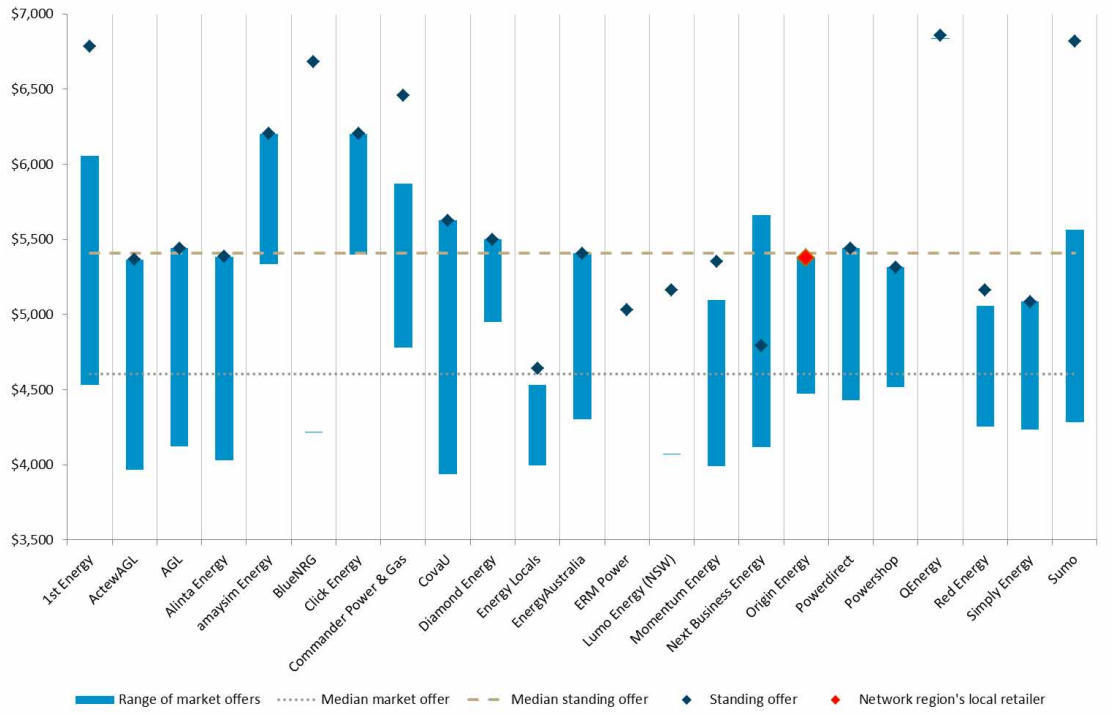
B SMALL BUSINESS SPREAD OF STANDING AND MARKET OFFERS

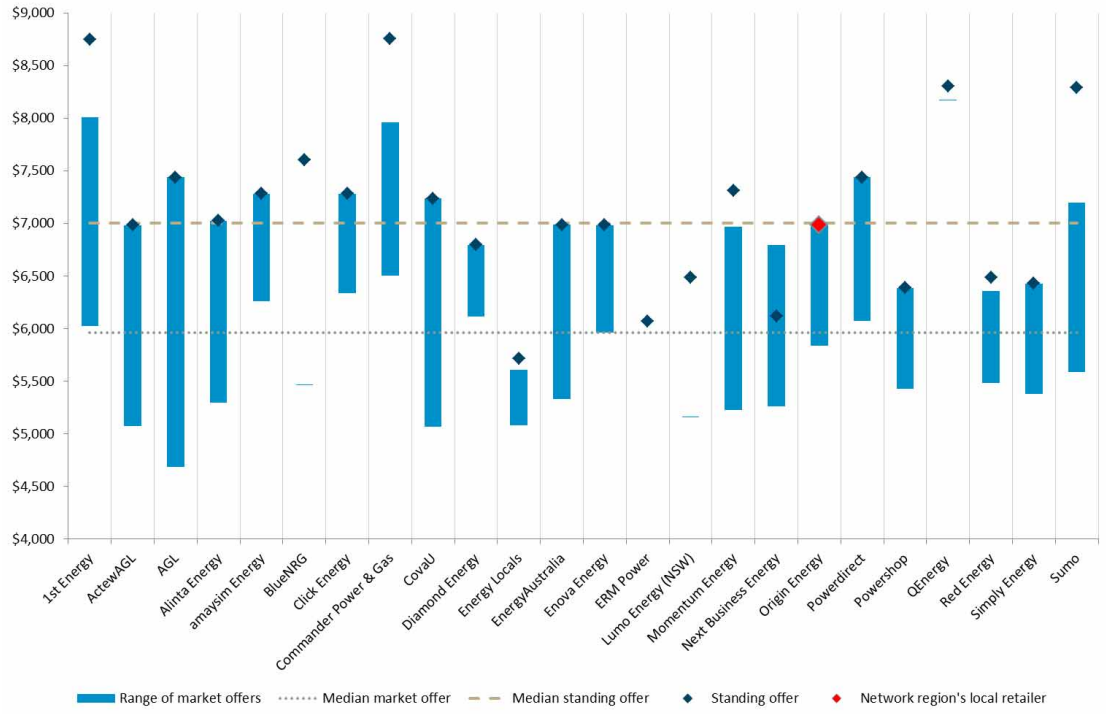
As discussed in Chapter 2, this Appendix shows the spread of annual bills of small businesses using all standing and market offers publicly available on *EnergyMadeEasy,* as of October 2018, which were not shown in the main body of the Report.

Figure B.1: Spread of small business annual electricity bills from flat rate offers - Endeavour Energy



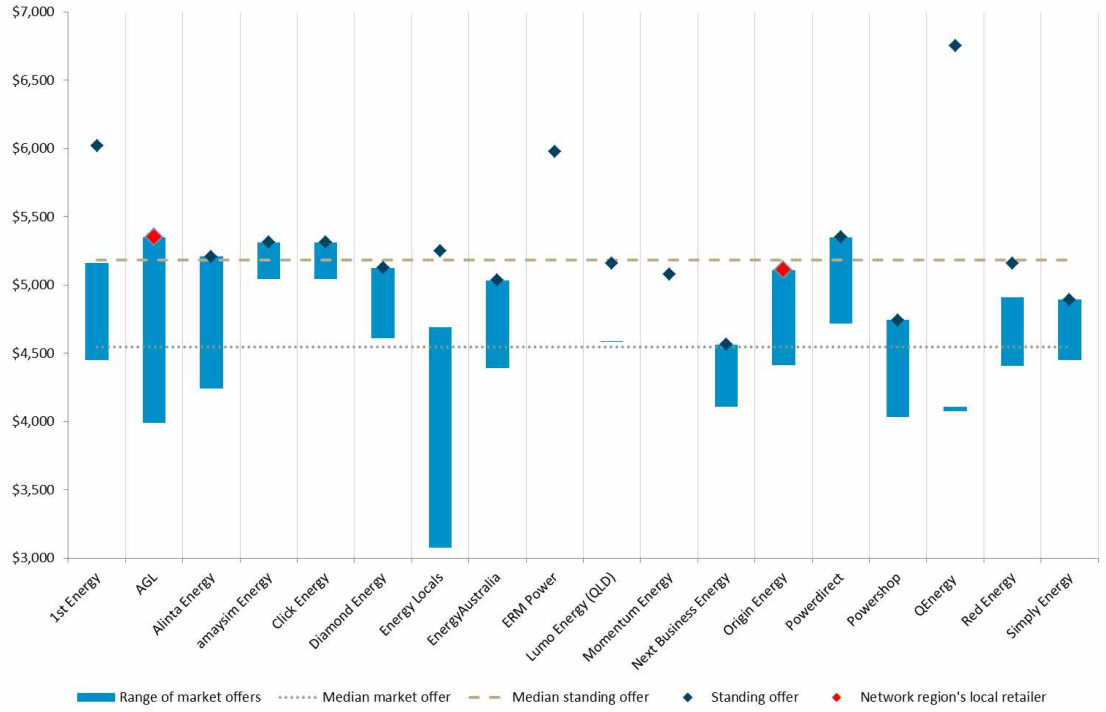
Source: EnergyMadeEasy, AEMC analysis.

Figure B.2: Spread of small business annual electricity bills from flat rate offers - Essential Energy



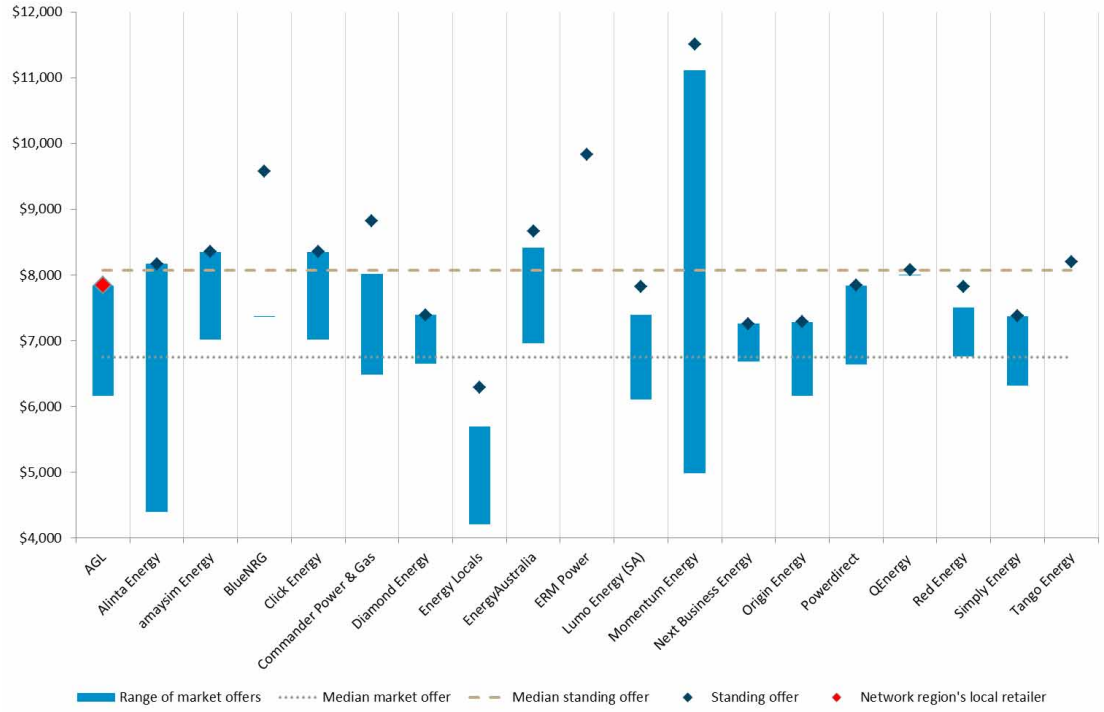
Source: EnergyMadeEasy, AEMC analysis.

Figure B.3: Spread of small business annual electricity bills from flat rate offers - Energex



Source: EnergyMadeEasy, AEMC analysis.

Figure B.4: Spread of small business annual electricity bills from flat rate offers - SAPN



Source: EnergyMadeEasy, AEMC analysis.

C METHODOLOGY

At the Commission's request, seven retailers provided a detailed breakdown of the standing and market offer customers they service in New South Wales, South East Queensland and South Australia. This appendix details the methodology for how the data was analysed.

C.1 Data sources

This section details the two main data sources used by the Commission in the analysis:

1. retailer's customer offer type by postcode data
2. socio-economic and demographic data.

C.1.1 Retailer's customer offer type by postcode data

Seven retailers, including the Big 3 and four Tier 2 retailers provided the Commission data to inform our analysis of the current landscape of the market in New South Wales, South East Queensland and South Australia. This data was provided as at October or November 2018 depending on the retailer's systems. The data provided represents 92 per cent of the total customer base of these jurisdictions and was provided at a postcode level, split into residential and small business customers.

C.1.2 Socio-economic and demographic data

Socio-economic and demographic characteristic data was obtained from the ABS 2016 *Census ofPopulation and Housing*. The datasets used in the analysis was divided into three main categories with subsequent subcategories as shown below.

1. Description on persons within the dwelling. This dataset counts the number of persons by postcode by:
    a. occupation
    b. highest level educational attainment
    c. age
    d. level of English Proficiency
        i. very well
        ii. well
        iii. not well.
2. Description of dwellings. This dataset counts the number of dwellings by postcode by:
    a. access to internet connection in dwelling
    b. tenure by type of dwelling
        i. occupied private dwellings
        ii. unoccupied private dwellings
        iii. non-private dwellings
    c. Type of non-private dwellings

   i. this data represents non-residential dwellings including hotels, boarding schools, hospitals, etc.
   d. number of persons usually residing in the dwelling.
3. Description of finances. These datasets are counts of the number of dwellings by postcode by:
   a. total personal income
   b. mortgage repayments.

C.2 Analysis

This section looks at the two levels of analysis conducted within this study, to determine the:

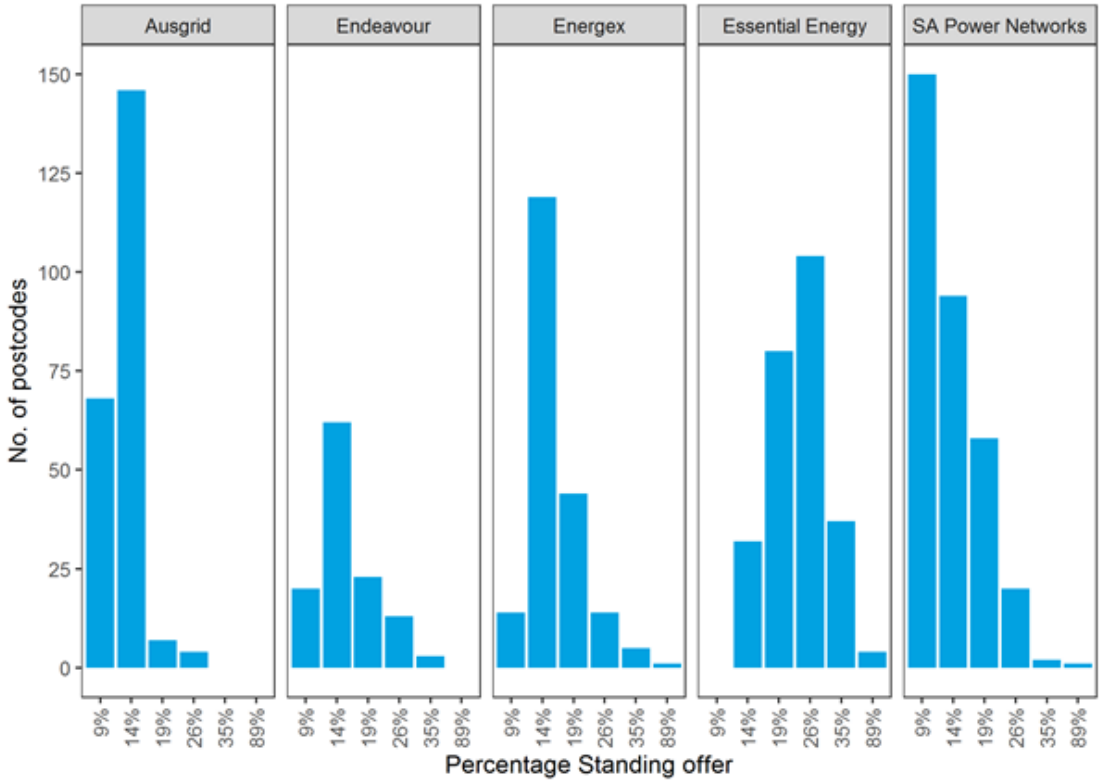
1. percentage of standing offer customers in each postcode
2. socio-economic and demographic characteristics of postcodes with a given percentage of standing offer customers.

C.2.1 Percentage of standing offer customers by postcode

The purpose of this analysis is to group different postcodes into clusters and identify where these different clusters are. A clustering algorithm, 'kmeans', was used to create six clusters by percentage of standing offers. The following results show the centroid or the mean of percentage of standing offers for each cluster. Heat maps were created by supply area. Figure C.1 below shows the centroids that each postcode is assigned to. This is, in effect, the average percentage standing offer for each postcode.

Figure C.1 shows the number of postcodes by cluster (represented by the mean of a percentage standing offer) by supply area. There are clear differences in the distribution. In particular, SA Power Networks has the highest number of postcodes with a mean of nine per cent standing offers while for Essential Energy network region the highest number of postcodes with a mean of 26 per cent.

Figure C.1: Count of postcodes by percentage standing offer centroids



Source: Data provided by retailers, AEMC analysis

C.2.2 Socio-economic and demographic characteristics of postcodes with a given percentage of standing offer customers

The main aim of this analysis who to identify certain socio-economic and demographic characteristics that influence the level of standing offers within the postcode. It should be noted that this analysis does not try to create a causal relationship between the socio-economic variable and demographic variables to a single consumer having a standing or market offer. The model tries to predict the percentage of standing offer for each postcode using socio-economic and demographic variables.

A decision tree based model (Extreme Gradient Boosting - xgboost - Chen, T. and Guestrin, C., XGBoost: A Scalable Tree Boosting System, source: https://arxiv.org/pdf/1603.02754.pdf) was selected as the main modelling algorithm. A main feature of tree based algorithms is the ability to identify variables that are most important in reducing the error of the model's prediction. The main dependent variable is the percentage of standing offers while the independent features are the socio-economic and demographic variables described in the data section.

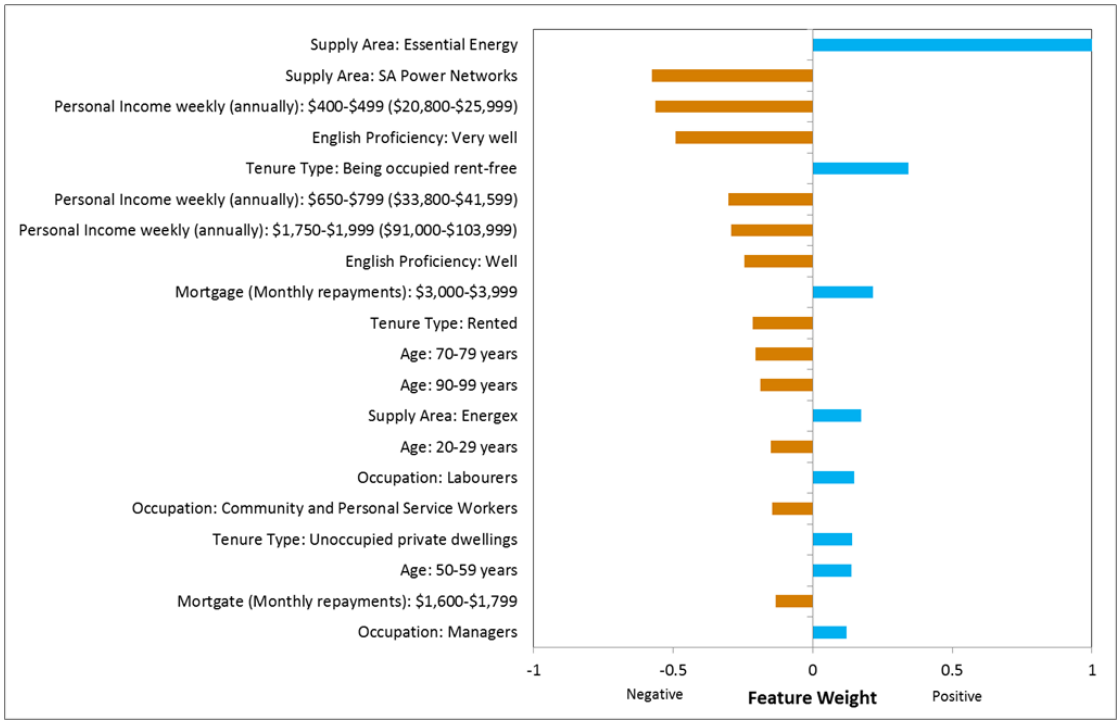
Method used in xgboost modelling

A fivefold, cross-validation technique was used to assess the accuracy of the predictive model. The goal of cross validation is to test the model's ability to predict an unseen dataset. This means running the xgboost algorithm on a rotating subset of data and assessing the model's performance on an unseen portion of the data, known as a testing set. A search grid was created to tune the hyper-parameters of the model with the final model selection criteria as the set of hyper-parameters that minimise root mean squared error.

Global results of the xgboost model

With the finalised model, we are able to extract the main features that improve the predictive power of the model. The top 20 features are shown in Figure C.2 below. The chart below shows the modelling features, namely the four main features types which help improve model performance are supply area, personal income, English proficiency, age, tenure type, occupation and mortgage repayments.

Figure C.2: Top 20 features



Source: ABS Census data, data provided by retailers, AEMC analysis

The analysis in Table C.1 below shows the conclusion from the top 20 importance features.

Table C.1: Demographic characteristics and their influence on percentage of standing offers

CATEGORY	SUBCATEGORY	POSITIVE OR NEGATIVE INFLUENCE ON THE LEVEL OF PERCENTAGE STANDING OFFER CUSTOMERS IN A POSTCODE
Supply area	Essential Energy network region	Increase
	SA Power Networks region	Decrease
	Energex network region	Increase
Income levels	Weekly income $400-499 (annually: $20,800-$25,999)	Decrease
	Weekly income of $650-$799 (annually: $33,800-$41,599)	Decrease
	Weekly income of $1,750-$1,999 (annually: $91,000-$103,999)	Decrease
English proficiency	High (Very well)	Increase
	Average (Well)	Increase
	Low (Not well)	Decrease
Tenure type	Being occupied rent-free (e.g. home owner)	Increase
	Rented	Decrease
	Unoccupied private dwellings (holiday homes, vacant houses)	Increase
Age of respondents	20 to 29 years old	Decrease
	50 to 59 years old	Increase
	70 to 79 years old	Decrease
Occupation	Managers (e.g. general managers, chief executives and legislators)	Increase
	Community and personal service workers (e.g. health and welfare works, carers, aides, hospitality workers, sports)	Decrease
	Labourers (e.g. cleaners, laundry works, construction, farm and forestry workers)	Increase
Mortgage	Monthly repayments: $1,600-$1,799	Decrease
	Monthly repayments: $3,000-$3,999	Increase