

17 April 2018

Australian Energy Market Commission
Level 6, 201 Elizabeth Street
Sydney NSW 2000

By online submission

Proposed Rule: National Energy Retail Amendment (Preventing discounts on inflated energy rates) Rule 2018 (Ref. RRC0012)

Energy Consumers Australia is the national voice for residential and small business energy consumers. Established by the Council of Australian Governments Energy Council (Energy Council) in 2015, our objective is to promote the long-term interests of energy consumers with respect to price, quality, reliability, safety and security of supply.

We welcome the opportunity to comment on the National Energy Retail Amendment (Preventing discounts on inflated energy rates) Rule 2018 (the Rule). This letter sets out our general comments on the proposal. Our responses to the questions posed in the Consultation Paper (the Paper) are included in the **Appendix**.

Energy Consumers Australia (ECA) supports the proposal for the Australian Energy Market Commission (the AEMC or the Commission) to expedite the consideration of this rule change. Of course, there remains a need for a bigger, systematic package of market reforms that we have detailed in our submissions to the ACCC Retail Review.¹

After a ten-year period where the energy prices have doubled, consumers have recently experienced further, very significant price rises. At a time when households and small businesses are doing everything they can to bring their bills down, consumers are telling us they want better information and tools and advice to get control over their costs.²

This rule change is part of an important package of retail market reforms being driven by the Prime Minister following his intervention in August 2017, and through the Australian Competition and Consumer Commission (ACCC) Electricity Supply and Pricing Inquiry. Energy Consumers Australia is deeply engaged in this work to reimagine the retail energy market: to bring prices down as quickly as possible, and to drive genuine innovation in services. Australian households and small businesses have a right to expect that their retailers will be transparent about their pricing, will work with them proactively to ensure they're on the right deal, and will help them manage their energy use. The fact that the current market is in many ways defined by the converse – by complexity and a lack of clarity about offers and prices or 'noise' – is what is driving recent interventions by governments. We are convinced that it will take significant, very concrete improvements in the way electricity and gas services are structured and priced to give governments the confidence that the community would support them stepping back from the market.

¹ <http://energyconsumersaustralia.com.au/publication/accc-electricity-supply-pricing-inquiry-preliminary-report-response-submission/>

² <http://energyconsumersaustralia.com.au/publication/energy-consumer-sentiment-survey-findings-december-2017/>

Addressing ‘noise’ in retail markets

We note the Commission’s position in the Paper that “generally, the energy offers that retailers can make to consumers should not be restricted through the NERR” while pricing presentation and marketing should be governed by the Australian Consumer Law (ACL) and the Retail Price Information Guideline (RPIG). The Commission’s view is that, “generally, a competitive retail energy market is better at producing energy offers that meet consumers’ preferences at prices they are willing to pay than regulatory measures which restrict the offers that retailers are able to make to consumers.”

ECA understands this perspective, however, it overlooks the path dependency created by the way competition was introduced in this market.

When retail competition is introduced, but before price regulation, the regulated Standing Offer is the price to beat by competitive providers. It is convenient to quote this as a discount off the standing offer. Once prices are deregulated each provider selects its own standing offer – they specify the price against which the discount is expressed.

Consumers for their part express a preference for offers expressed as discounts. Over time, however, this generates an offer comparison problem for consumers as the headline discounts become increasingly difficult to compare.³

Orthodox economics is usually silent on the origin of consumer preferences. Institutional economists beginning with Thorstein Veblen consider the social setting within which preferences are formed. John K Galbraith in *The Affluent Society* identified the role that producers themselves play in creating consumer preferences and hence demand, writing:

As a society becomes increasingly affluent, wants are increasingly created by the process by which they are satisfied... Wants thus come to depend on output. In technical terms, it can no longer be assumed that welfare is greater at an all-round higher level of production than at a lower one. It may be the same. The higher level of production has, merely, a higher level of want creation necessitating a higher level of want satisfaction. There will be frequent occasion to refer to the way wants depend on the process by which they are satisfied. It will be convenient to call it the Dependence Effect.

The point in the context of this rule change is that the (notional) consumer preference for discounts isn’t innate, it has been developed by industry conduct.

The resulting retail market is one which can be characterised as consisting of ‘noisy consumer product evaluations.’ Gabaix and Laibson have analysed markets in which rational firms sell goods to consumers who evaluate products in a noisy market. They show that competition generally has a remarkably weak impact on markups.⁴ When noise is made an endogenous variable – a variable firms adjust to maximise returns – firms choose excess noise by making their products inefficiently confusing. Moreover,

³ Paul Simshauser ‘Price discrimination and the modes of failure in deregulated retail electricity markets’ (Unpublished manuscript) provides a convenient summary of these developments and the supporting literature.

⁴ These specific results appear in a mimeo ‘Competition and Consumer Confusion’ (https://www.researchgate.net/profile/David_Laibson/publication/4900160_Competition_and_Consumer_Confusion/links/02e7e51d4d1e56ff00000000/Competition-and-Consumer-Confusion.pdf) a more general (but consistent) result was published in Xavier Gabaix, David Laibson, Deyuan Li, Hongyi Li, Sidney Resnick, Casper G. de Vries, ‘The impact of competition on prices with numerous firms,’ *Journal of Economic Theory*, Volume 165, 2016, Pages 1-24, ISSN 0022-0531, <https://doi.org/10.1016/j.jet.2016.04.001>

competition exacerbates this effect; more competition causes firms to choose even more excess complexity. Firms with lower intrinsic quality and higher production costs choose the most excess complexity.

The theory suggests that educating consumers to help them navigate the noise and choose the best deal would generate large welfare gains by reducing costs and improving services for consumers. However, because the gains accrue mostly to the consumer, firms can't profitably educate consumers and entice them away from competitors.⁵

Consequently, having created a market based on discounts that is resulting in price confusion, there is no incentive for retailers to reduce the noise in the market. Importantly, the theory lines up with anecdotal feedback from many of the retailers we speak with, who tell us they'd like to innovate – to offer simpler prices – but feel compelled to counter noise with noise to survive.

Consequently, to promote the long-term interests of consumers, it is appropriate for the Commission as rule maker (market designer) to take action to reduce the noise. As we explained in detail in our second ACCC submission, complexity and noise in the retail market is acting as a major impediment to efficiency enhancing innovation by retailers, including rewarding consumers for shifting their consumption.

The proposed rule

The intent of the rule proponent is to address one aspect of the 'noisy consumer product evaluation'; the circumstance in which the stated discount is calculated from an inflated underlying price. The AEMC is proposing a suite of reforms to achieve the intent of the proposed rule.

As noted above, the presentation of retail offers is guided by the ACL and RPIG, with the latter in prescribing the way price offers are presented. The AEMC is proposing to enhance the ability of the Australian Energy Regulator (AER) to enforce the RPIG requirements through the provision of civil penalty provisions. This is not achieved through the Rule change but through the COAG Energy Council agreeing to amend the Retail Regulations. ECA supports this proposal.

The AEMC has proposed a refinement to the proposed rule that targets the circumstances where all the charging components in the market offer before discount are worse for the consumer than the charges in an equivalent standing offer. We support this refinement as it targets more accurately the specific conduct of inflated reference prices rather than just different offer structures.

The Paper discusses a concern that the proposal could prohibit offers that better suit the consumer's consumption pattern. Genuine price innovation will result in more sophisticated underlying price structures, accompanied by advanced pricing tools (such as comparison services that can access household consumption data) will convert these structures to straight-forward choices. We therefore believe the AEMC's concern is unfounded because innovative offers are structured in ways in which there is no equivalent standing offer.

We also note the AEMC's concerns about defining pricing structure concepts in the Rules. We anticipate that further Rule changes, possibly arising from the ACCC Retail Inquiry, may be required and will provide an opportunity for further refinement. We do, however, encourage a distinction between 'prices'

⁵ These specific results appear in a mimeo 'Competition and Consumer Confusion' (https://www.researchgate.net/profile/David_Laibson/publication/4900160_Competition_and_Consumer_Confusion/links/02e7e51d4d1e56ff00000000/Competition-and-Consumer-Confusion.pdf) a more general (but consistent) result was published in Xavier Gabaix, David Laibson, Deyuan Li, Hongyi Li, Sidney Resnick, Casper G. de Vries, 'The impact of competition on prices with numerous firms,' *Journal of Economic Theory*, Volume 165, 2016, Pages 1-24, ISSN 0022-0531, <https://doi.org/10.1016/j.jet.2016.04.001>

as the charges that consumers see from retailers and ‘tariffs’ as the charges retailers see from networks. In making this distinction we note that a ‘tariff’ usually does not include any element of optionality and hence is appropriate only for network charging.

Energy Consumers Australia supports the AEMC’s proposed Rule on the basis that it fulfils the specific intent behind the rule change.

Expectation on retailers

In an effectively competitive market, retailers would take responsibility for their customers’ energy outcomes.

The above limitations to the market becoming effectively competitive should be apparent to retailers. While individual retailers may not have an obvious incentive to reduce the noise in this market, retailers collectively – the industry – certainly does.

We understand that retailers may have justifiable concerns about possible competition law breaches if they meet to discuss price structures. However, where such discussions would ultimately benefit consumers there is a well-developed authorisation process used in many other industries.

It is therefore important that retailers monitor the effectiveness of this Rule change over time, and if necessary, refine their approaches in an iterative way in line with an understanding of consumer behaviour informed by behavioural insights.

If you have any questions regarding our submission please contact Sabiene Heindl, Director Strategic Engagement on 02 9220 5500 or sabiene.heindl@energyconsumersaustralia.com.au.

Yours sincerely,

Chris Alexander,
Director, Advocacy and Communication

Appendix

Issues Raised

1. Prevalence of the issue raised in the rule change request - How prevalent is this practice of discounting in market offers where any (or all) of the demand, usage or daily supply rates are above these rates in the equivalent standing offer in the same distribution supply area? How prevalent has this practice been historically?

As the ACCC has highlighted in its Preliminary Report into the Retail Electricity Market (the ACCC Report), the practice of discounting is widespread in the retail electricity market.⁶ As stated in our submissions to the ACCC, our proposition is that:⁷

The design of the retail electricity market is determining outcomes in upstream markets. The retail market is operating primarily as a 'coupon market'. Consumers are offered inducements to switch suppliers through discounts with the expectation that they will then migrate to a higher priced offer.

Primarily retailers are simple price takers of network and wholesale prices and regard them as a pass through. Competition by headline discount mitigates against the introduction of innovative offers.

We are not in a position to comment on the practice of discounting in market offers where any of the demand, usage or daily supply rates are above the rates in the equivalent standing offer, however understand anecdotally that there have been instances of this in the recent past.

We encourage the ACCC to look at the broader issues relating to discounting more generally to ensure better consumer outcomes.

2. Standing offers - Do stakeholders agree that retailers applying discounts in market offers to rates above that retailer's standing offer rates is inherently confusing?

Energy Consumers Australia is of the view that applying discounts in market offers to rates above the retailer's standing offer is inherently confusing. We note the reference in the consultation paper to the action taken against a retailer in 2015 for a discount that was found to be misleading and deceptive under the Australian Consumer Law (ACL). The fact that the discount was specified on a base other than the retailer's generally applicable rate was a relevant fact in the retailer's admission that it had engaged in misleading and deceptive conduct, but the case as a whole was primarily about the conduct of the retailer's sales agents.

Given the already complex state of retail offers in the market and the reliance upon discounts as a marketing practice, as highlighted and acknowledged by the ACCC in its Report, a reasonable consumer would not expect or anticipate that discounts themselves would be off a base that is higher than the retailer's standing offer. However, ECA acknowledges that while the practice is clearly confusing, it may be more difficult to establish that it is misleading or deceptive.

3. Standing offers as a "base rate" - Should standing offer rates be considered base rates, or effectively a "cap", for the purpose of applying discounts to market offers?

⁶ <https://www.accc.gov.au/publications/accc-retail-electricity-pricing-inquiry-preliminary-report>.

⁷ <http://energyconsumersaustralia.com.au/wp-content/uploads/ACCC-Electricity-Supply-and-Pricing-Inquiry-Preliminary-Report-Response.pdf>.

We support mechanisms preventing market retail contracts that have discounts applied to rates above the “equivalent” standing offer rates. Thus effectively “capping” the rates for energy market offers (containing discounts) to each retailer’s standing offer rates.

We note that standard “base rates” are a common practice understood by consumers. In the case of electricity, customers in embedded networks use standing offer rates as a reference price.

4. Appropriateness of ACL and RPIG - Are the ACL and the RPIG generally the appropriate mechanisms to govern retailers making and advertising market offers to consumers?

Generally, the ACL and the Retail Pricing Information Guidelines (RPIG) are appropriate mechanisms to govern the marking and advertising of market offers to customers.

However, in circumstances where the market is in a sub-optimal equilibrium (as it is with discounting), then specific mechanisms should be considered.

5. Civil penalty recommendation - Should a civil penalty provision be added to sections 25 and 37 of the NERL, in respect of the requirement to present standing and market offers in accordance with the RPIG? What would be the benefits of doing so? What would be the costs?

As discussed above we support this recommendation.

6. Direct prohibition within the NERR - Should some specific types of market retail contracts be expressly prohibited under the NERR?

As discussed above, the retail market (just as much as the wholesale market) is subject to the design inherent in the Rules. Where the operation of the market is resulting in adverse outcomes for consumers and the incentives are such that individual retailer action cannot rectify it, then either the industry co-operatively, or the Rules as a market design instrument, need to rectify it.

7. Market retail contracts to be directly prohibited - Do you agree with the Commission’s initial discount prohibition as applied to the market retail contracts as set out in section 4.2.2?

As discussed above we support the proposed Rule subject to it not using the word ‘tariff’ in the definitions.

8. Exclusion of fees and penalties - Do you agree with the exclusion of fees and penalties from consideration of whether there is an equivalent standing offer in the Commission’s initial position?

We agree with the AEMC’s initial position and indicative drafting to exclude the consideration of fees and penalties in comparing a market retail contract to an “equivalent” standing offer.

9. Materiality and discretion for the AER - Do you think the concept of materiality for differences between tariff structures and benefits and services in standing offers and market retail contracts is appropriate?

We support the concept of materiality to allow the AER discretion to apply the proposed Rule in line with its proposed spirit and intent. This provides the flexibility needed to ensure better consumer outcomes are achieved in the market.

At this point we reiterate ECA’s preference for reserving the word “tariff” to refer to the charges that retailers pay to networks and to only use the word “prices” to refer to the charges consumers pay retailers.

10. Equivalency on energy payments - The basis on which energy payments are made may differ between market retail contracts and standing offers. Is it appropriate for differences of this

kind to prevent the standing offer being an equivalent standing offer (assuming the other conditions for equivalence are met)? If not, what approach would be preferable?

We agree that differences in the way in which energy payments are made between the market retail contract and the standing offer should not be grounds upon which the standing offer is not considered to be an equivalent standing offer. In our view being too prescriptive about the equivalency on energy payments has the potential to dramatically reduce the scope of this proposed Rule and its potential for better consumer outcomes.

11. Market retail contract and standing offer availability to the same customer - The Commission's initial position relies upon the market retail contract and standing offer being available to the same small customer (if the retailer were the designated retailer for the customer's premises) for matching the market retail contract to the standing offer for the discounting prohibition on energy rates to take effect. Is this appropriate?

We believe that this is an appropriate requirement. The relationship between standing and market offers will need to be closely monitored to guard against unintended consequences for consumers – particularly in relation to the role of standing offers as the mechanism that must be used by designated retailers to comply with their statutory obligation to make offers to small customers. It is the safety net offer that enables any consumer to be able to access electricity. For some of the most vulnerable consumers (for reasons of income, health or personal circumstances), the standing offer may be the only product they will be able to access.

We would therefore be concerned about any move by retailers to increase standing offer rates to maintain revenue from their current suite of products.

12. Energy rates and energy payments - Do you consider that the definitions of energy rates and energy payments in the indicative drafting are clear and workable? Please note any potential ambiguities or items that you consider should be specifically included in or excluded from these concepts.

As mentioned before we prefer that the term 'tariff' is restricted to refer to network charges payable by retailers. The definition of energy rates could be revised to be more consistent with the definition of energy payment as "means any charge payable to the retailer by a small customer that is a component of the offer prices under a market or standing retail contract, excluding charges that are fees or penalties."

Energy Consumers Australia has not responded to the remaining questions. These appear to us to relate more to the ability of retailers to operationalize the rule as opposed to how the rule provides benefit or cost to consumers.