AXIOM economics

Standing Offer Electricity Retail Prices: the Adverse Consequences

A number of commentators have claimed lately that electricity retail margins are too high in some of the Australian states in which price regulation has been removed and that this shows that competition is not working.[1] Victoria – the state that has been open to competition for the longest – bears the brunt of much of this criticism. Others – including the retailers themselves – have disputed that characterisation and say that margins are not too high and that the market is functioning just fine.[2]

It is hard to say who is right. Accurately measuring retail electricity margins and drawing inferences about the state of competitive rivalry is notoriously difficult. The data required are extensive and almost never available. This means that the estimates of retail margins coming out of various studies – including of the Victorian market – can provide only a rough idea of the true level of profitability. There is really not much they can reliably tell us about whether prices are too high.

But setting aside the issue of whether the price *levels* are excessive, what about the way that prices are *structured*? In particular, what of the role of the standing offer? This is the 'default' offer that a retailer must apply when a customer has never switched to a 'market' contract, or was previously on a market contract that has since expired.[3] The way that retailers have used these standard offers to 'frame' their other prices – their 'market offers' – has the potential to create significant problems for customers.

The potential problems with standing offers

Throughout Australia, standing offers are now widely used as a pricing benchmark. A strategy commonly adopted by retailers when promoting their competitive 'market' offers is to advertise the deal as representing a certain discount off its prevailing standing offer price. For example, an offer might be marketed as delivering, say, a '10% discount' off the retailer's standing offer. This might seem a perfectly reasonable way to communicate price information to customers in a simple way.[4] Why make customers grapple with, say, prices per kilowatt hour consumed? Who even knows what a kilowatt hour is?

Of course, ten years ago, most people did not know what a Gigabyte was either. Today, most smart phone users have a pretty good idea of what this unit of data is worth, and comparing pricing plans on that basis is second nature to them. This means that when Telstra is charging, say, $30 for 1GB of data and Vodafone is charging only $25 (to use a simple example), then most customers will have a good sense of "how much" data that comprises – i.e., how many hours of videos they will be able to stream, how many emails to send, and so on – and it is obvious which provider is cheaper.

Things are not necessarily so straightforward in the electricity retail sector. If one retailer is advertising a market contract at, say, a 12% discount off its standing offer rate and another is advertising basically the same offer at, say, a 10% discount, which is the best deal? When presented in this way, the 12% discount looks the better of the two. But is it? Well, it depends on the standing offer prices to which the discount is being applied. If the first retailer's standing offer price is significantly higher, then its proposition might actually be the less attractive of the two.[5]

Of course, the customer may not realise that and mistakenly select the deal with the bigger discount, even though the *actual price* she will end up paying is higher. And therein lays the problem. Even if this pricing practice was initially well-intentioned (i.e., to convey pricing information as simply as possible), as it has become more ingrained, it has provided retailers with stronger incentives to raise their standing offer prices. Indeed, why not ratchet up standing offer prices over time and advertise markets offers with bigger and bigger discounts? The motivation is clear enough:

- It may lead to a retailer winning more customers, since its market offers may appear more attractive – even if they are not.
- On top of that, a retailer will make more money from those customers who, for whatever reason, remain on the standing offer.

Not a bad outcome; at least for the retailer – perhaps not so much for customers. Of course, if some customers do not really care what they pay and would rather not spend their time investigating cheaper options, then we arguably should not be too bothered if they wind up paying higher standing offer prices. That is their prerogative. But if some other customers *do* explore their options and end up inadvertently picking more expensive plans because of confusing discounts, then that is a different story.

There is also the matter of vulnerable customers who have may have difficulty switching away from standing offers, e.g., because they do not speak English as their first language. These customers will be especially disadvantaged by the current pricing practice. To be sure, these types of customers often get a raw deal in other markets but, the critical difference here is that they have *no choice* but to consume electricity. So it is not quite the same as buying, say, a pair of shoes, where this is always the option to buy nothing.

It might be tempting just to chalk this up to 'efficient price discrimination' or 'market segmentation'. But it is not quite that simple. Efficient price discrimination involves charging higher prices to customers who are prepared to pay more – in this case, because they value their time too much to bother looking for a better deal. But as we have already seen, it is not just those customers who will pay more when prices are structured in this way. Some price sensitive customers may find themselves paying more as well:

- The use of standing offers as a benchmark for pricing will harm vulnerable customers who cannot switch, or have great difficulty in doing so.
- It may also cause price sensitive customers who do switch in an effort to obtain a better deal to make inadvertently poor choices.

That is a potential problem. Ironically, recent enforcement action by the Australian Competition and Consumer Commission may also have served to entrench the status of the standing offer as the relevant reference point for retail pricing.[6] So what should be done about it? There are a number of potential policy responses, ranging from the relatively 'light-handed' to full-scale market intervention. Some of these options may have merit and others, not so much.

Potential policy responses

One response to the problems set out above would be to re-introduce a regulated tariff in states that do not have them, so as to directly reduce standing offer prices. However, that could lead to more expensive market offer prices and higher average price overall. Littlechild (2015)[7] describes precisely that occurring in the United Kingdom when a 'non-discrimination' condition was imposed by the energy market regulator, Ofgem, from 2008-2012. All in all, re-regulation is probably a bad idea.

Alviss Consulting and St Vincent de Paul Society (2015)[8] have suggested placing restrictions on the timing and frequency of standing offer price changes. Specifically, they have recommended a change that would require standing offer prices to be gazetted on the same day by all retailers, every six months. Those offers would also be accompanied by a brief statement that explains why prices have increased, decreased or remained unchanged.

The intention appears to be that, once retailers have gazetted their standing offer, they would not be able to change them for the next half year. The idea therefore seems to be that retailers would consequently have strong incentives to err on the *low* side when setting standing offers so that they looks more appealing to prospective customers for the ensuing six months. However, it is not obvious that the proposal would actually have that effect.

Given the way in which standing offers have come to be used as a 'reference point' in the market, it is probably just as likely that retailers would respond to such a reform by erring on the *high* side when setting their standing offers. That would then allow them to advertise even higher discounts on their market offers in the manner described above. Although well-intentioned, the proposal could therefore have the unintended consequence of increasing prices, on average. As such, it is most likely another bad idea.

Of course, there is also the option of simply stopping retailers from having to provide a standing offer at all. But that begs the question: what happens when a customer moves into a new house and does not contract with an electricity retailer? What tariff should be charged? The obvious answer is: none – the connection could simply expire with the departure of the previous customer and the premise would be 'cut off', as it were. Unfortunately, it is not quite that simple:

- What if the customer has already moved in and started using electricity before that disconnection can happen?
- What about when a customer's market offer is coming to an end and she does not pick a new contract before it expires?

In both cases, it is not possible, in practice, to immediately disconnect the customer – there is bound to be a period in which she is 'uncontracted', but still using electricity. There therefore needs to be some form of arrangement for determining what price she should be charged for the power that she consumes during that period. In other words, these practical complications make it difficult to eradicate completely the need for some kind of 'default' tariff to be applied in such situations.

But that is not cause for dismay. As we have seen, the problems associated with standing offers stem not from their existence *per se*, but from the way they are used to frame market offers. It is therefore not necessary to get rid of them completely to address the problems

they may cause. A 'lighter-handed' response would be to try and promote further customer awareness, so that they are more engaged, and less likely to be led astray by confusing price comparisons.

The public sector has a potentially important role to play in this respect. One of the key themes to emerge from the Australian Energy Market Commission's (AEMC's) recent reviews of retail competition is that customers are more likely to trust information provided by governments or regulatory agencies.[9] State governments and community groups may also be well-placed to increase awareness – including amongst vulnerable customers. For example:[10]

- State governments might undertake targeted campaigns (e.g., advertising in different languages and through local radio and niche newspapers).
- Campaigns could emphasise the potential gains from switching, the hazards to avoid when doing so and the importance of *continuing* to switch when market offers expire to avoid defaulting back to the standing offer.
- Price comparison websites funded by governments or regulators could also be made as simple to use as possible and available in multiple languages.

These customer engagement strategies may not be the most 'dramatic' responses. Yet they are arguably the most effective way of improving outcomes for customers in the near-term, without giving rise to unintended adverse effects. In particular, they may help to reduce the number of previously unengaged or vulnerable customers that remain on standing offers, and decrease the incidence of customers mistakenly switching to the wrong plan when there were better options available.

Over the longer-term, there are several other forces afoot that may make it difficult for incumbent retailers to maintain their current pricing practices. Firstly, following a recent AEMC rule change, electricity distribution businesses are required to set 'cost reflective' network tariffs. This will affect directly retailers' input costs and, in turn, may influence the way in which they structure their own prices. For example, distribution businesses could well start introducing things like 'peak demand charges', which is significant because:

- It could well usher in a greater variety of price structures at the retail level that harness smart metering technology, e.g., more time-of-use pricing packages, etc.
- If so, it will become harder for retailers to continue to advertise market offers as entailing a simple discount off a standing offer price.

Secondly, a relatively recent market entrant – Powershop – is now offering plans that bear little resemblance to its competitors, .e.g., it is offering market contracts with no fixed fees.[11] Although it is only a small competitor at the moment, if its offers prove attractive or more new entrants offer innovative products, then the other existing retailers will be forced to respond in kind or to offer their own innovations. This too will make it more difficult for incumbent retailers to keep marketing their offers in the same way.

Thirdly, and perhaps most importantly of all, the advent of new technologies may soon see consumer electronics companies competing for the customer's retail dollar. For example, firms such as LG, Tesla, Bosch, Samsung and Panasonic (to name just a few) are already

selling battery storage solutions. These devices enable customers who drive electric vehicles, or have solar panels on their roofs to store the electricity harnessed from those sources. That storage can then be used when the household needs it or sold back into the grid.

As the cost of these devices drop – which they surely will – more and more customers will install them, reducing the amount of energy that they draw from the grid and taking greater control over their energy needs. If retail prices at that time are still based to a substantial extent on the amount of electricity that customers use – largely irrespective of the times of day they do so – then retailers could see their revenues plummet. Is it therefore hard to see how the current retail pricing structures can be sustained in the longer-term.

In all likelihood, retailers will be forced to rethink completely the way that they set prices and to provide broader suites of innovative products. That may make it impossible to frame products against the standing offer in the way that many do now. If that is the case then, in ten years' time – perhaps even sooner – it is possible that electricity retail customers will be as familiar with the term 'kilowatt hour' as they are with the term 'Gigabyte.' If so, the problems described above will be a thing of the past.

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1 *See for example:* CME, *A critique of the Victorian retail electricity market,* A report for the Brotherhood of St Laurence, June 2015 (hereafter: 'CME (2015)'); Alviss Consulting and St Vincent de Paul Society, *The NEM – still winging it, Observations from the Vinnies' Tariff-Tracking Project*, September 2015 (hereafter: 'Alviss and St Vincent (2015)'); Dr Ron Ben-David, *If the retail energy market is competitive then is Lara Bingle a Russian cosmonaut?*, 22 June 2015 (hereafter: 'RBD (2015)').

2 *See for example:* Electricity Retailers Association of Australia, *Letter to Mr Neil Howes*, Australian Energy Market Commission, 5 July 2013; and Stephen Littlechild, *Regulation of Retail Energy Markets in the UK and Australia*, 26 September 2015 (hereafter: 'Littlechild (2015)').

3 It is also the tariff that is applied to customers when their retailer goes out of business and they are transferred to their 'retailer of last resort'.

[4] It perhaps also made sense in a context in which retailers were initially required to continue offering a regulated tariff for a period before full deregulation, i.e.., 'market offers' could be advertised as entailing a particular discount off the standard regulated tariff.

[5] Complicating this comparison is the fact that retailers may now have more than one type of standing offer. For example, following the deployment of advanced interval meters in Victoria, retailers in this state must now also offer standing offers that vary by the time-of-use (such as 'peak', 'off-peak' and 'shoulder' periods).

[6] For example, the ACCC brought a successful action against Origin Energy, alleging that it had misled customers in South Australia by representing that under its DailySaver energy plan they would receive a discount of 16% for electricity and 12% for gas when, in fact, in each case the discount was off rates that were higher than its standing offer. See: *Australian Competition and Consumer Commission v Origin Energy Limited* [2015] FCA.

[7] Littlechild (2015), pp.3-4.

[8] Alviss and St Vincent (2015), p.42.

[9] See: AEMC, *Final Report, 2014 Retail Competition Review, To COAG Energy Council 12 August 2014*, p.24.

[10] Many of these steps are set out in the AEMC's 2013 consumer engagement blueprint. See: *AEMC consumer engagement blueprint.*

[11] The *quid pro quo* is a higher unit rate for electricity usage. *See: Powershop website.*