

12 December 2024

ATT: Australian Energy Market Commission

Dear Commissioners

This submission responds to the Commission's consultation paper, *The pricing review: Electricity pricing for a consumer-driven future*, November, 2024.

Given submissions responding to the draft terms of reference do not appear to have had any bearing on the final terms of reference or the consultation paper, I have kept this submission short and largely without narrative. My papers over the past year-or-two provide further elaboration (references and links provided).

Unlike the old joke about the lost travellers entering a pub asking for directions, the Commission has a choice over where it 'starts' this review.

As I stressed in my submission on the draft terms of reference, the Commission must choose a different starting point if it is to avoid revisiting the same ineffectual outcomes as every other review of the consumer-facing energy market. It must eschew well-worn tropes about markets and consumers; and it must not let assumptions get in the way of reality.

This submission again encourages the Commission to "rethink how it thinks" about upholding consumers' confidence in the energy market — and in doing so, ensuring ongoing community support for the energy transition.

To this end, this submission proceeds as a series of observations. For the most part, they are presented in no particular order. The submission then describes the implications of these observations for the review and its proposed approach. A short postscript looks further afield.

(Note, page numbers in the following text refer to the relevant pages in the consultation paper.)

I would welcome the Commission's interest in discussing these matters.

Yours sincerely

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About the author

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Productivity isn't everything but in the long run it's almost everything.

Paul Krugman¹ on national prosperity

Risk isn't everything but, for now, it's almost everything.

Ron Ben-David² on consumer energy market reform

¹ Krugman, P. *The Age of Diminished Expectations*, MIT Press, 1990)

² Ben-David, R (November 2022)

1. INTRODUCTION

The Consultation Paper (the Paper) opens with the ambitious statement:

“[W]e must continue to challenge our thinking to avoid being constrained by the way things are done now. We invite you to do the same in working with us on this review.” (p.ii)

While the Paper goes on to describe various objectives, it ultimately relies to the same solutions to which every other review of the consumer energy market has gravitated. This is precisely the outcome my earlier submission foreshadowed and warned against.³ That submission referred to these ‘solutions’ as the “four mores” (where more can also mean: better).

While the consultation paper uses slightly different terminology, it nonetheless has not resisted the gravity of conventional thinking.

RBD’s submission (Aug 2024)	Consultation paper (Nov 2024)
More choice	Meaningful choices, Innovative offerings
More information	Right information, Compare and understand
More shopping around	Engagement, Consumer preferences
More (efficient) price signals	Right incentives, Save money

This submission responds to the paper’s invitation to challenge the Commission’s thinking so that it avoids being constrained by “the way things are done now”.

The following section draws attention to some important features of the energy market. Section 3 reflects on the implications of these observations for the review. Section 4 draws on the earlier sections to offer some thoughts on market reform. Section 5 offers a postscript that draws attention to an overlooked question and how it might be solved – *To what problem is pricing the solution?*

³ Ben-David (August 2024)

2. SOME RELEVANT OBSERVATIONS

The energy market is not just another consumer market.

- Unlike in other consumer markets, active consumer participation in the energy market (“shopping around”) is not motivated by the search for greater utility (eg. comfort, ease, enjoyment, etc).
- Financial gain is the sole purpose of active market participation.
- The energy market is – or is becoming – the most complicated consumer-facing market in the economy.

The lessons of history should not be assumed away.

- Retail competition has been in place for 20+ years with a regulatory expectation that consumers shop around to find the ‘best’ deal.
- There is an abundance of evidence showing that consumers do not behave as expected – resulting in the vast majority of consumers leaving substantial dollars ‘on the table’.
- In other words, the evidence shows the promise of financial gains from shopping around for an energy deal has been – and therefore should be expected to remain – a weak motivator of consumer behaviour.

Choice matters but matching matters more.

- The choice-set for energy consumers is expanding rapidly, adding to the burden of decision-making by consumers.
- The paper seems to be inviting reform options for enabling more choice for consumers – seemingly including choice over additional “default products and services” (p.18).
- Greater choice will benefit consumers who are proficient navigators of the market but will make navigation even more difficult for many-or-most other consumers.
- More choice increases the risk (and likelihood) that consumers will not choose (ie. be matched with) the ‘right’ contract for their circumstances.

Poor matching exposes consumers to financial risks they may not be well-placed to understand, manage or price.

- Requiring consumers to choose between contracts they may not understand, or understand sufficiently, exposes them to the risk of financial outcomes they do not expect, are unable to manage, and/or are unprepared to bear.

The long-term interest of consumers is not a regulatory objective.

- The national energy objectives give no special standing to the long-term interests of consumers when it comes to market and regulatory design.
- Despite the comments on pp.22-23 of the consultation paper, the law does not require the energy market regulators to consider (or be guided by) the long-term interests of consumers.⁴

There is no objectively correct [network] tariff structure.

- There is no objective way to determine an “efficient [network] tariff” (p.20) that “precisely reflect network costs” (p.22).
- The structure of tariffs unavoidably relies on a series of subjective judgements.
- Those judgements determine the distribution of benefits, costs and risks among consumers. Tariff decisions are therefore, unavoidably, about equity.

Overall outcomes are important, but no more important than individual outcomes.

- Relative consumer outcomes matter in the energy market because consumers face near-insurmountable barriers to exit.
- The much-hated “loyalty tax” demonstrates the redistributive consequences of a market that disproportionately rewards consumer proficiency (in navigating the market) when consumers are faced with barriers to exit.
- The ubiquity of the loyalty tax was the consequence of the herding incentives created by the energy market’s rules for retailers.
- If during the energy transition, the energy market’s rules enable and support financial benefits to be captured by only the most proficient consumers, then support for the energy transition will be imperilled.

Community support for the energy market (and energy transition) is an exercise in political economy, not just economics.

- History shows consumers do not just express their dissatisfaction by exercising market choice (ie. switching plans or provider). Instead, history shows dissatisfied consumers will demand a political or regulatory ‘fix’.
- It is irrational for regulators to ignore the likelihood of these “predictably unpredictable” fixes when designing the market.

⁴ The law does not differentiate between the “long-term interests of consumers” and “efficient investment in, and efficient operation and use of, electricity services.” See Ben-David (December 2024)

3. IMPLICATIONS FOR THE REVIEW

The consultation paper suffers from *optimism bias*.

- Like almost every other regulatory review of the consumer-facing energy market, this review only asks, “What will go right when the proposed reforms are implemented?”
- In doing so, it relies on a wide suite of assumptions about consumers and markets that are not properly aired or tested (or empirically supported).
- One example of optimism bias can be seen in the five ‘vignettes’ presented on pp.8-10. These vignettes assume each of the five types of customers is optimally matched with one of five types of products. It would be more illustrative of reality to assess the consequences for customers when they are mis-matched with the available products.

It’s all about risk, not preferences.

- If consumer utility is not the motivator of consumer behaviour (as noted above) then the consultation paper is misguided when repeatedly referring to satisfying consumers’ preferences.
- In reality, what matters is consumers’ understanding of, appetite for, tolerance of, and skill and interest in managing their exposure to financial risk.

The consumer archetypes should be refocussed.

- The use of consumer archetypes is helpful but the two parameters applied by the consultation paper (resources and interest) are not the primary factors of relevance.
- The paper’s two archetypal factors do not reflect the likelihood of contractual mismatching.
 - Access to ‘resources’ (p.15) will broaden a consumer’s choice set, but it infers nothing *a priori* about their risk appetite or their proficiency, that is, the likelihood of a contractual mismatch.
 - ‘Interest’ (p.15) in engaging in the market is only one of many necessary conditions for a successful match. Nothing much can be inferred about outcomes from a consumer’s level of interest.
- A more realistic framework for describing consumer archetypes would distinguish consumers based on:
 - **Risk appetite** – describing consumers’ differing tolerance for – and/or willingness and capacity to manage – volatile, unexpected or unpredictable financial outcomes.
 - **Proficiency** – describing consumers’ differing skills and effectiveness in navigating the market in search of a contract that matches their risk appetite.

Are misaligned tariff structures welfare enhancing?

- If retailers are not expected to pass through to consumers the structure of network tariffs (p.21), then retailers will be exposed to risks they will need to manage.
- Managing risk imposes a cost that must be recovered. It is most likely these costs will find their way into the retail prices (and bills) paid by the least proficient consumers.
- If retailers are expected to offer tariff structures that respond to consumers' needs⁵, then it is not clear what welfare benefits (or efficiencies) are gained by network tariff structures that differ from retailers' tariff structures. Any such differences create costs for retailers that are passed on to consumers – potentially resulting in dead weight losses.

Efficiency is not the only consequence of pricing. It is probably not even be the main consequence.

- The primary consequence of tariff design – network and retail – is the distribution of benefits, costs and risks among consumers.
- Barriers to exit, when coupled with consumers' lack of proficiency in navigating the market, means risks (and associated costs) flow to those consumers who are least able to avoid them – rather than to “the parties who are best placed to manage them.” (p.26)
- Price signals motivated by theories of efficiency will shift risks (and costs) on to those consumers who do not behave according to the assumptions embedded in those theories.
- Pricing theories are only theories no matter how internally consistent and complete they may seem.

⁵ See (p.1) “the role of retailers and energy service providers in effectively packaging and pricing electricity products and services to match consumer preferences”, (p.13) “when contemplating energy offerings, ‘price’ will be the most important preference for almost all consumers”, and (p.23) “Retailers are best placed to understand consumer preferences”.

4. RETHINKING MARKET REFORM

- The **objective of any reforms** to the consumer facing energy market should be:
 - To avoid exposing consumers to risks [and costs] they are ill-equipped to understand, manage or price.where the relevant “risks” *inter alia* includes:
 - contract outcomes that do not align with a consumer’s interests
 - price, tariff or cost structures that assume particular responses by consumers that are unlikely to be met.
- In line with this objective, market and regulatory design should **establish an ‘inner’ and ‘outer’ consumer energy market** (alternative descriptors may be preferred).⁶
 - The inner market would provide a ‘safe harbour’ from risks and costs consumers are ill-equipped to understand, navigate or manage. Prices would be governed by strict policy and regulatory principles in the inner market – see below.
 - In choosing to participate in the outer market, consumers would accept the risks and benefits of participating in the broader energy market through trading their load, production and/or storage. Minimal regulation would apply – see below.
- Some preliminary **design principles for the inner market:**
 - The inner market should offer a limited set of simple consumer-facing tariffs for customers with and without CER assets.
 - Any price-based incentives are designed within socially acceptable limits.
 - Prices in the inner market should include *no* headroom provisions – such as competition allowances and allowances for commercial retail margins.
 - Hedging costs are based on a reasonable and fair minimising and/or sharing of volatility risk within and across the *inner* market.
 - Network tariff structures are aligned with the tariffs faced by consumers in the inner market.
- Two overarching **design principles for the outer market:**
 - A statutory duty of care (or similar) should require providers of energy services to [make reasonable endeavours to] act in the best interests of the customer when offering or providing services under contract.⁷
 - Most other retail market regulations and consumer protections should be repealed to remove potential barriers to innovative product, services and prices structures.

⁶ See Ben-David (July 2024), Section C.4, *Structural reform: The final frontier*.

⁷ See Ben-David (April 2022), Part 3, *Establishing a new duty of care*.

5. POSTSCRIPT: To what problem is pricing the solution?

But are we sure?

- The emerging electricity market is entirely unique. No other market has so-called, ‘consumers’ potentially acting as one-or-more of: users, buyers, producers, sellers, storers and arbitragers of a perfectly fungible ‘thing’.
- We have no economic models for this type of market. We do not know if it produces a welfare enhancing outcome. We do not even know if it is stable (with stable dynamics); or whether it is computationally solvable.⁸
- In reality, the Paper just proceeds on the assumption (or belief) that this market solves like all others. This assumption might be right, but then again, it might not.

A different approach

- As a rule-making body, the Commission is understandably seeking to establish the case for any future rule changes that might be needed to enable more products and services into the consumer-facing energy market.
- It is not clear what market end-state the review is pursuing or how its approach – of enabling more choice over products, services and pricing structures – contributes to achieving that end state.
- For now, a better investment would see a ‘taskforce’ of unencumbered economists, mathematicians, engineers and philosophers tasked with developing an understanding of how the future electricity market will work and then, properly specifying the problem to be solved through pricing.

⁸ I intend further exploring these questions in 2025 which will extend beyond just the actions of consumers with multiple market ‘personalities’.

Further reading (* key papers for this review)

Ben-David, Ron (December 2024) ***On borrowed time? The future of the retail energy market.*** Presented to Energy Retail Excellence conference. Melbourne.

https://www.monash.edu/_data/assets/pdf_file/0004/3835966/Ron-Ben-David-On-borrowed-time-The-future-of-the-retail-energy-market-December-2024.pdf

Ben-David, Ron (October 2024) ***Submission to the Select Committee on Energy Planning and Regulation in Australia.*** See submission no.64 at:

https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Energy_Planning_and_Regulation_in_Australia/EnergyPlanning/Submissions

* Ben-David, Ron (August 2024) ***Electricity pricing for a consumer-driven future.*** Submission to the Australian Energy Market Commission.

<https://www.aemc.gov.au/sites/default/files/2024-09/240822%20-%20EPR0097%20-%20Ron%20Ben-David.pdf>

* Ben-David, Ron (July 2024) ***What if the consumer energy market were based on reality rather than assumptions?***

https://www.monash.edu/_data/assets/pdf_file/0007/3733441/Ron-Ben-David-What-if-the-consumer-energy-market-were-based-on-reality-rather-than-assumptions-July-2024.pdf

Ben-David, Ron (January 2024) ***Meditations on an imaginary electricity market.***

https://www.monash.edu/_data/assets/pdf_file/0011/3537119/Meditations-on-an-imaginary-Electricity-Market.pdf

Ben-David, Ron (August 2023) ***Rethinking markets, regulation and governance for the energy transition.*** A paper prepared for the ACCC/AER Regulatory Conference 2023.

<https://www.accc.gov.au/system/files/Ben%20David%20R.%20Rethinking%20markets%2C%20regulation%20and%20governance%20for%20the%20energy%20transition.pdf>

Ben-David, R (June 2023) ***On collision course: Economic regulation and the energy transition.***

[2306b-Ron-Ben-David-On-collision-course-Economic-regulation-and-the-energy-transition-June-2023.pdf](https://www.monash.edu/_data/assets/pdf_file/0010/3528307/2306b-Ron-Ben-David-On-collision-course-Economic-regulation-and-the-energy-transition-June-2023.pdf)

Ben-David, R (June 2023) ***Regulatory over-reach in the energy transition. A case study: Gas tariffs***

https://www.monash.edu/_data/assets/pdf_file/0010/3528307/2306a-Ron-Ben-David-Regulatory-over-reach-in-the-energy-transition.pdf

Ben-David, Ron (November 2022) ***Minimising consumer harm for a successful energy transition.*** IPART 30th Anniversary Conference.

https://www.ipart.nsw.gov.au/sites/default/files/cm9_documents/Ron-Ben-David-Minimising-Consumer-Harm-IPART-30-year-conference-%2817-November-2022%29.PDF

* Ben-David, Ron (April 2022) ***Energy market uncertainty, consumer protection, and a new duty of care.***

A response to the Australian Energy Regulator's retailer authorisation and exemption review.

https://www.monash.edu/_data/assets/pdf_file/0004/3528202/Energy-market-uncertainty.-consumer.pdf

Ben-David, Ron (November 2018) ***Fairness in the age of competition.*** Presentation to the Regulatory Policy Institute of Australia and New Zealand.

<https://static1.squarespace.com/static/5b7f71a12487fd3b14217dde/t/5bed021f575d1f1bd378f772/1542259242738/1811+Fairness+in+the+age+of+competition.pdf>

Ben-David, Ron (July 2015) ***If the retail energy market is competitive then is Lara Bingle a Russian cosmonaut?***

<https://www.esc.vic.gov.au/sites/default/files/documents/If-The-Retail-Energy-Market-Is-Competitive-Then-Is-Lara-Bingle-A-Russian-Cosmonaut.pdf>