29 April 2014

Australian Energy Market Commission
PO Box A2449
SOUTH SYDNEY NSW

Dear Mr Pierce

Retailer Price Variations in Market Retail Contracts—Rule Change

As proponents of the above rule change, Consumer Action Law Centre and the Consumer Utilities Advocacy Centre write to respond to some of the key issues identified by submissions to your consultation paper on this rule change.

In their submissions, both the Australian Energy Regulator (**AER**) and the Department of State Development and Business Innovation (Victoria) (**DSDBI**) recognise that consumers can be deterred from engaging fully in the competitive energy market.

However, the AER suggests that the central problem is "that some customers do not understand that a fixed term contract ... does not mean that the price they are charged for energy is also fixed for the period of that term". DSDBI suggests there are two possible descriptions of the central problem:

- "contracts that allow for price increases during a fixed term are unfair for consumers, as they are contrary to the nature of a fixed agreement; or
- the different types of contracts in the energy retail market are not easily differentiated or understood by consumers, and as a result consumers may find themselves on fixed term, variable price market offers to their dissatisfaction".

Despite acknowledging that the problem may be with the nature of fixed contracts, DSDBI's submission states that the problem may be addressed through efforts to improve consumer awareness and understanding of the nature of contracts.

As the proponents for this rule change, we submit that the AER and DSDBI have mis-characterised the problem (and how it may be addressed) as being about consumer awareness and understanding. While indeed consumers can be misled by the offering of fixed period contracts that allow for price variations, the central problem is that such contracts and consumers' engagement with them is likely to lessen competitive pressure in the marketplace. Even if consumers are aware that fixed period contracts allowed for price variation, they are less likely to engage because such contracts offer them very limited benefit.

As noted in our submission to the consultation paper, we encourage the AEMC to consider research findings from consumer behaviour and behavioural economics studies in considering this issue. The following findings are particularly relevant:

- Consumers tend to disengage when faced with complexity: More and complex choices, or requiring consumers to consider a number of product parameters when making a decision, can result in consumers not making choices. Consumers already have to consider different tariff options, different contract lengths, different conditions on discounts etc when making a decision to enter an energy contract. Requiring consumers to consider the risk of the price—a central feature of the consumer contract—increasing at different points throughout a contract is likely to be de-motivating and reduce the likelihood of consumers making choices.[i]

- Consumers have a bias towards the default option (status quo bias):[ii] Even if fixed price, fixed period contracts are in the marketplace, these are unlikely to be taken up unless it is the "regular" offer. Regulators and policy makers are already aware of the problems with consumers staying on expensive "standard" contracts—around 30 per cent of Victorian households have not switched to market offers despite being able to do so for over 10 years. While "rate freeze" products have entered the marketplace, these are likely to be niche unless they are offered as a retailer's default product.

- Consumers tend to use heuristics (experience-based techniques or "short cuts") to problem solving which is not likely to be optimal: Even if consumers are informed in mandated price disclosure fact sheets that prices can be varied, they are likely to rely on stronger or key messages that contracts are "fixed". This is based on the finding that people have two modes of decision-making, intuition and reasoning, and that our decision-making mistakes often result from use of the wrong mode.[iii]

- Consumers are bad at computation, and prefer a small reward today over a larger one later: Consumers are likely to choose a lower-priced, variable-rate fixed period contract over a rate-freeze contract, even if the premium built into the rate-freeze contract is a lesser total cost than the potential price rises that are passed through over the period of the variable-rate contract. This has been described by Oren Bar-Grill as a "behavioural market failure".[iv]

In other consumer sectors, there has been widespread acknowledgment that more information and disclosure about complex consumer choices is unlikely to be an effective solution. Indeed, regulators responsible for financial services[v] and telecommunications[vi] have researched the effects of behavioural economics in those industries, and have promoted reforms to choice architecture that improves the ability of consumers to make effective choices. The Office of Best Practice Regulation has also written on this issue.[vii]

In short, this research has found that knowledge alone is not enough, and policy makers must consider actual consumer behaviour when designing regulatory responses. We encourage the Australian Energy Market Commission to undertaking research about actual consumer behaviour, or at least reviewing the evidence available, in considering this rule change application.

We look forward to discussing this with you further.

Yours sincerely

Gerard Brody, CEO
Consumer Action Law Centre

Jo Benvenuti, Executive Officer
Consumer Utilities Advocacy Centre

cc. Andrew Reeves, Chair, Australian Energy Regulator
Mark Feather, Executive Director, Department of Business Development and State Innovation (Victoria)

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[i] In consumer experiments, it has been found that limiting the amount of choice makes more people more likely to purchase products: S Iyenger and M Lepper (2000)), "When choice is demotivating: can one desire too much of a good thing?", Journal of Psychology and Social Psychology", Vol 79, No 6, page 995-1006.

[ii] Status quo bias was a key reason for the "MySuper" reforms, which used "choice architecture" to ensure that those that the default choice is safe: Cooper et al, *Super System Review—final report*, available at: http://www.supersystemreview.gov.au/.

[iii] This is the central thesis of Nobel prize winning economist Daniel Kahneman's book, *Thinking, Fast and Slow* (2011).

[iv] Oren Bar-Gill (2011), *Competition and Consumer Protection: A Behavioral Economics Account,* NYU Law and Economics Research Paper No. 11-42, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1974499.

[v] Australian Securities and Investments Commission (2011), Report 230: *Financial Literacy and Behaviour Change*, available at: http://www.financialliteracy.gov.au/media/218309/financial-literacy-and-behavioural-change.pdf

[vi] Dr Patrick Xavier (2011), *Behavioural Economics and Customer Complaints in Communication Markets,* A report prepared for the Australian Communications and Media Authority, available at: http://www.acma.gov.au/Industry/Telco/Reconnecting-the-customer/Public-inquiry/communications-behavioural-economics-research-reconnecting-the-customer-acma.

[vii] Office of Best Practice Regulation (2012), *Influencing Consumer Behaviour: Improving Regulatory Design*, available at: http://ris.dpmc.gov.au/2012/12/18/obpr-research-paper-influencing-consumer-behaviour-improving-regulatory-design/