From Universal Service to NO SERVICE?

The Redlining of Vulnerable Electricity Customers in Victoria

Andrea Sharam
Electricity is widely recognised as an essential service required for a minimum standard of living acceptable to a developed nation like Australia.

In anticipation of "full retail competition", it is called, certain provisions have been made by the Victorian government and the Office of the Regulator-General to have minimum standards of consumer protection for these small customers. However, breaking with the past and differing from the United States, the United Kingdom and New Zealand, the Victorian government has not mandated an obligation to supply to households. Rather, it has provided for a temporary obligation to offer (the standing offer) which lasts until December 2003. This "safety net" provision requires a current host retailer to offer supply to small customers. The price, however, is to be set above the market in order to not undermine competition, which effectively means that vulnerable customers will be forced to pay a premium above the market. If they cannot afford to do so, they will be denied supply.

After 2003 there is no obligation to supply or offer. In markets, not all customers are equal, and therefore are not treated equally. Vulnerable customers - those on low incomes, with low consumption, in rural and remote areas or who have experienced payment problems in the past - will all be at risk of price/service discrimination in such a market. This discrimination is called "redlining".

The consumer protection framework for full retail competition or the 'minimum standards' do not protect vulnerable customers from redlining, but in many instances enable it to occur. The obligation to offer provision itself, as a legally sanctioned monopoly price, redlines all customers from the outset, achieving what it would take the market some years to achieve.

In addition, the regulation of the monopoly distribution businesses - the 'poles and wires' function which comprises between 60 and 85 per cent of the household bill - also permits redlining.

Redlining has been well documented in the insurance and credit industries in the United States, and is now a major concern in deregulated telecommunications, gas and electricity. Evidence of redlining has also emerged in the United Kingdom since deregulation of electricity. In Australia, the deregulation of telecommunications and banking has seen substantial changes that could be described as redlining. It is an economically rational strategy aimed at allocating costs onto customers who have the least capacity to avoid them, or to encourage low return customers to move to another supplier. In this way, a retailer can increase their overall rate of return.

This report recommends that there be a legal obligation to supply and that an anti-redlining consumer protection framework be developed for full retail competition.

It also recommends that:
- The standing offers be abandoned in favour of another mechanism to protect vulnerable customers who are unable to obtain benefits in the market;
- Substantial effort be made to reduce household consumption and that cross-subsidies for air conditioning load, in particular, be removed;
- Reduction in consumption of vulnerable households be linked to a safety net, with emphasis on retrofitting; and
- The governments overseeing the National Electricity Market address a number of serious flaws in the market as a matter of urgency.

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SUMMARY

Not every electricity customer is equally profitable to serve. Not every area costs the same to serve. In a deregulated industry, electricity service sellers that operate solely on a for-profit basis may be allowed to choose freely whom they will serve and the rate they will charge each customer. If they do, they can be expected to segregate customers by geographic area, past credit records and income level, and sell to the most attractive customers. If they do, what price quality at what price can people in high-cost, difficult to serve, areas expect? How will people with lower incomes be assured they can afford electric service? Unless these questions are equitably resolved, deregulation will not benefit the whole nation (Alliance to Protect Electricity Consumers (US); 1998).

In developed nations, fuel for heating, cooking and lighting are recognised as essential services that are fundamental to quality of life. Users do not purchase 'electricity' but a 'means' to provide heating for their homes, the capacity to cook, lighting for security and social participation. Electricity is the means by which key welfare goals are achieved and as such is considered a 'right'. In the Australian context, state ownership of electricity supplies for the best part of the last century was coupled with the objective of 'universal service obligation' - that all customers are entitled to supply at a fair and reasonable price. Universal service in areas like utilities, banking, insurance and health were underpinned by cross-subsidies between customer groups, localities and generations. Nevertheless, fuel poverty - deprivation or rationing of fuel - was and remains a social and health problem. It is caused by several factors: low income, poor thermal quality of the housing stock, poor appliances (especially space and water heating), tariff structures and lack of an appropriate welfare safety net.

The supply of electricity in Victoria has undergone radical reform over the past ten years, intended to transform the industry from a state owned monopoly business to a fully competitive market. The final act of the reform process is to deregulate the supply of energy to households in January 2003. "Full retail competition" (FRC), as it is called, anticipates that residential users will be able to purchase their energy from a range of competing providers. This is a profound change. Not only is the concept of universal service to be abandoned, but there is to be no fundamental obligation to supply: the market is to determine the receipt of benefits. This report argues that, under the current arrangements for FRC, this will mean a change from universal service to no service for many Victorian households. It is also likely to mean that a great number will be effectively forced to pay more than they should for this essential service in order to secure supply.

Consumer participation in markets is reliant on two key factors: the consumer's ability to pay and the right to be served. Where a consumer cannot afford a good or service, they cannot obtain what is needed or wanted. Firms operating in free markets orientate their business towards consumer groups that are able to pay. In order to maximise the return on their investment, investors seek to increase the margin of profit on each sale as per customer. This involves particular pricing and distribution strategies and the minimisation of bad debt. It is self-evident why expensive luxury stores locate in wealthy suburbs and why shops in poor neighbourhoods tend to sell only everyday necessities. Where a consumer has no choice, firms in free markets are able to charge more than is fair and reasonable. Markets work to segment customers and actively engage in discrimination. It can be either a positive form of discrimination - commonly called 'cherry-picking' - and orientated towards affluent customers, or it can be negative and intended to deny service or over-charge for the service.

In the United States, such negative economic discrimination - sometimes based on racial and other prejudices, but not exclusively so - is called 'redlining'.

The United States provides a useful contrast and a powerful lesson in market design. In areas such as insurance and banking, price/service discrimination has been rife for decades. Consumer organisations and low income advocates quickly recognised the emergence of a familiar pattern once the United States deregulated its telecommunications industry. As various states deregulated their electricity supply industries, redlining has already become a major issue. The United Kingdom, importantly, provides empirical evidence of redlining, post-FRC. Victoria stands in stark contrast to the United States, the United Kingdom and New Zealand, who all deregulated their electricity industries, in that each of these countries has maintained a legal obligation to the right of supply at a fair and reasonable price. Victoria does not and, as a consequence, the effects of the markets on vulnerable customers are likely to be much more severe.

Market segmentation in a deregulated electricity industry is a two-part strategy. Firstly, it seeks to discriminate in favour of those customers who can be encouraged to increase their consumption and those with attractive consumption profiles. Secondly, it
The regulation of the monopoly the industry itself promotes discriminatory customers, including those in rural and remote economic efficiency that is used to justify contribution to revenue. As such, the claim of customer, but the customer is that the utilities have economic incentives to can be forced to contribute additional revenues and/or low income because they contribute prices have traditionally been relatively cheap, but a focus on the causes of fuel poverty has been lacking. The existing welfare safety net has not served the needs of the most vulnerable customers. A ‘whole of government’ approach should address the poor housing, stock and poor appliances, mandate appropriate tariff structures and match financial rebates with programs to reduce consumption.

To that end, this report seeks to encourage debate around the implementation of safety nets and whether these really are the solution to redlining, or whether there needs to be a fundamental shift in our thinking about the nature of competition.

The inevitability of redlining of customers of essential services poses a serious policy and political hurdle for governments embracing market reform. This report outlines the measures that can and should be taken to protect vulnerable electricity customers. Such protection - indeed, the elimination of fuel poverty - is possible with a ‘whole of government’ approach. Victoria’s electricity prices have traditionally been relatively cheap, but a focus on the causes of fuel poverty has been lacking. The existing welfare safety net has not served the needs of the most vulnerable customers. A ‘whole of government’ approach should address the poor housing, stock and poor appliances, mandate appropriate tariff structures and match financial rebates with programs to reduce consumption.

The marketisation of the electricity industry must be acknowledged as problematic from the outset because the industry does not have the characteristics that are held to exist in ‘perfect’ markets.

For example:
- Electricity must be used as it is produced and cannot be stored in quantity as with conventional commodities;
- Significant parts of the industry (distribution and transmission) will always be monopolies;
- The purchase by households is non-discretionary (inelastic demand) and is in many instances non-substitutional;
- For large customers, it may be difficult or too expensive to substitute the fuel source; and
- Substantial public goods and merit goods are involved (infrastructure, rural development) and significant negative externalities exist (pollution).

A perfect market should have:
- Many consumers and suppliers;
- Perfect information; and
- Appropriate pricing signals to which buyers can respond and influence the market outcome.

The NEM lacks appropriate information levels for all customers, does not permit appropriate price signals, and generation ownership is arguably concentrated enough to allow market manipulation. The reliance on market discipline to deliver consumer benefits therefore is perhaps misplaced.

**From a welfare perspective, an important aspect of the reform process has been the removal of ‘social programs’ from the utilities themselves and the re-creation of some of these programs as ‘community service obligations’ (CSOs). Victorian retailers, for example, are paid by the government to deliver its winter energy concession program. Other important programs such as demand management and retrofitting have been abandoned. However, certain utility practices both implicitly and explicitly contain social objectives. Tariff structures, for example, can be highly regressive (as they are currently) or progressive. The Kennett government intended to have the reform of the electricity industry result in cost reflective pricing or ‘user pays’. In doing so, it was dismantling the central redistributive function provided by the SECV. FRC as it is currently being pursued is likely to be a redistributive function provided by the SECV.**

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The only grounds on which customers are differentiated are economic grounds, the very grounds on which low income consumers are exposed to discrimination as they require flexibility in debt collection practices and credit management policies...this lack of understanding has resulted in many low income people having to go without energy, water or other essential services. Low income people experiencing difficulty paying their bills are confronted with disconnection or restriction, or they sacrifice essential expenditure, such as food and clothing, to be able to pay their energy and water bills.

Romeril (1998) presents evidence of the substantial increase in disconnection during the corporatisation and early privatisation phases of electricity reform. Economist Roger Colton (1995a) and Colton (1995b) also points to the rush to disconnect when California deregulated its electricity industry.

Southern California Edison has already cited competition as the primary reason to change its collection practices. In that case Southern California Edison chose to treble its service disconnection (up to one million customers in 1995 alone), citing competition as the main reason it was calling in debt.

Both Colton (1995a) and Kliger (1998) state that debt and discrimination policies need to recognise the requirement for repayment plans to be based on the customer’s ability to pay in order to ultimately avoid disconnection. In some situations, Kliger argued, this will require moratoriums and waivers.

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The financial and consumer rights Council argues on the basis of two sets of case studies (Beveren et al and Walker 1995; Kliger 1998) that vulnerable consumers are already worse off because of the emphasis on market objectives. As Kliger (1998: 2) said:

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THE REDLINING DEFINITION

The term ‘redlining’ is a US term that refers to the practice of literally drawing a red line around an area on a map in order to clearly delineate it for discrimination in the delivery of a service or good. This was the method by which credit providers and insurers in the United States identified neighborhoods they wished to deny service because of views about the customers’ creditworthiness or assessment of possible profits. Historically, this concerns a perception of financial risk correlating with race and/or crime, hence neighborhoods that were generally black, ethnic and/or poor were targeted. In this sense, it has a geographical basis; all persons within a particular area will be discriminated against regardless of race, although the discrimination is effectively racist in origin. Property insurance, for example, may be denied because of a fear of civil unrest in poor predominantly ‘black’ neighborhoods. Not only are the black people discriminated against, but so are any other groups who happen to live in the area. By and large, the practice is outlawed in the United States, but minority rights groups maintain that it continues and providers are still being taken to court. As new industries emerge, new redlining appears. Internet-based store Azana.com has already attracted the attention of the Equal Rights Centre for engaging in ‘consumer racism’ (ZD Net News 2001).

Recognition of economic discrimination provides an important distinction between rational and irrational market behaviour. Colton (1999: 69) says:

The state of Georgia (1997) provided the following definition in a bill supporting anti-redlining legislation for the insurance industry:

Defining the type of market exclusion that one seeks to prevent is important for purposes of deciding upon the public policy responses establishing appropriate remedies for the objectionable behaviour. If, on the one hand, the exclusion which one seeks to prevent involves irrational and uneconomic decision making (e.g. based on stereotypes and prejudice), the appropriate response might be simply to promote increased competition. This competition would increase the potential emergence of a firm that would serve this unserved, or under-served, yet profitable market.

IT shall be unlawful for any electric service provider to discriminate against any person with respect to any aspect of a consumer transaction on the basis of race, color, creed, national origin, age, gender, religion, source of income, receipt of public benefits, family status, credit status, sexual orientation, disability, or geographical location.

These definitions reflect much of what is contained in human rights legislation in Victorian and Commonwealth statutes. The main distinction is the inclusion of matters pertaining to ‘economic rights’. To this end, such a definition could be described as a ‘bill of rights’ for smaller consumers. But, as the state of New York Public Services Commission (2001) points out, a general legal obligation to supply removes the need to identify individually all the forms of discrimination that may be envisaged.

Price/service discrimination has a positive as well as a negative aspect. Competition for affluent (attractive) customers is known as ‘cherry-picking’. In a market that will permit bundling of non-utility services with electricity provision, these customers have even greater attraction. It provides the scope for cross-subsidisation between different products or services as well as between customer classes.

THE CONSUMER PROTECTION FRAMEWORK

IN VICTORIA FOR FULL RETAIL COMPETITION

4.1 An Obligation to Supply?

The consumer protection framework for full retail competition in Victoria is mandated by the Electricity Industry Acts (Amendment) Act 2000. Section 169A provides for the creation of what are now called the standing offers and Section 169B for the deemed contracts. Both sections oblige the ORG to set the terms and conditions of supply, excluding prices. Prices are to be set by the retailers, subject to reserve pricing powers contained in Section 156AA. The deemed contracts simply transfer the franchised small business and residential customers from the MCT which expired on 31 December 2000 to a temporary tariff that will cease to exist after December 2003. The provisions of Section 169A require that retail licensees are obliged to offer a tariff (subject to ORG approval) to small business and residential customers until 31 December 2003. The government put both sections of the Act into effect by the Order in Council of 21 September 2000. However, the issue of how pricing oversight of deemed contracts and standing offers would be managed in practice was not subject to public consultation at the time, and the legislative and regulatory instruments are silent on the matter. It took until the middle of 2001 for the government to initiate the development of pricing guidelines by a ‘Special Reference’ to the ORG under Part 4A of the Act.

<table>
<thead>
<tr>
<th>Purpose</th>
<th>Application</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Transfer all franchise customers from MCT (MUT ended December 2000)</td>
<td>• Provide a safety net for consumers (retailers required to make offer)</td>
</tr>
<tr>
<td>• Maintain near uniform prices across Victoria</td>
<td>• Subject to government reserve pricing powers</td>
</tr>
<tr>
<td>• Provide transitional arrangement, to avoid all customers needing to switch on first day market is open</td>
<td>• Prices must be quoted 60 days prior to commencement</td>
</tr>
<tr>
<td>• Three year duration only (ending December 2003)</td>
<td>• Fixed price (no pass-throughs)</td>
</tr>
<tr>
<td>• Subject to government reserve pricing powers</td>
<td></td>
</tr>
</tbody>
</table>

The following tables set out the three main contract types, their purpose and application.

Table 1: Deemed Contracts

<table>
<thead>
<tr>
<th>Purpose</th>
<th>Application</th>
</tr>
</thead>
<tbody>
<tr>
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</tr>
<tr>
<td>• Three year duration only (ending December 2003)</td>
<td>• Service standards/conditions must comply with ORG Retail Code</td>
</tr>
</tbody>
</table>

Table 2: Standing Offers

<table>
<thead>
<tr>
<th>Purpose</th>
<th>Application</th>
</tr>
</thead>
<tbody>
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</tr>
<tr>
<td>• Three year duration only (ending December 2003)</td>
<td>• Service standards/conditions must comply with ORG Retail Code</td>
</tr>
<tr>
<td>• Opportunity to vary conditions as per Retail Code</td>
<td>• Sunset provision (December 2003)</td>
</tr>
</tbody>
</table>

The deemed contracts and standing offers are currently identical in price and conditions, with the exception of Origin’s internet-based standing offer.

Table 3: Market Contracts

<table>
<thead>
<tr>
<th>Purpose</th>
<th>Application</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Deregulation of customer/supplier relationship</td>
<td>• Tariff negotiated between retailer and customer</td>
</tr>
<tr>
<td>• No obligation to offer</td>
<td>• Permits pass-throughs such as ancillary service payments</td>
</tr>
<tr>
<td>• Tariffs/prices not required to be published</td>
<td>• Compliance with Retail Code but self-regulation</td>
</tr>
<tr>
<td>• Conditions can be varied</td>
<td></td>
</tr>
</tbody>
</table>
These standing offers will cease to exist after December 2003

There are two reasons for this concern:

1. The technical systems required to facilitate retail competition for that group of customers may not be fully implemented by 1 January 2001, so that, although legally entitled to choose between retailers from that date, it may not be possible in practice for the customers to do so; and
2. It is likely to take some time for those customers to become adequately informed about the choices available to them and how those choices can be exercised.

As a result of these concerns, the government wishes to ensure that it has the necessary reserve power to regulate retail prices payable by this last group of franchise customers, or, possibly, a subset of those customers, as a transitional measure until a competitive retail market is adequately developed. Whether the bill makes provision for both those and other matters too.

However, the government is concerned that the protection afforded by the competitive market may not be adequate for the last group of franchise customers including domestic and small business customers, particularly in the initial stages of the market’s development.

Broad’s speech was followed in the Council by another government member, Glenn Romanes, on 31 May.

In addition, in putting forward a fundamental consumer rights protection regime, the bill provides for a supplier of last resort obligation on the retail electricity industry to ensure there is always a retailer from whom electricity can be bought. Further, it recognises and references obligations on electricity retailers to perform community services and provides for deemed contractors to carry over domestic and small business customers from January 2001 (Hansard, Parliament of Victoria, Legislative Assembly: 1713).

The existing standard to display a graphical illustration of a customer’s consumption will be retained, but customers can vary this range of choices through the bill, which will make provision for both those and other matters too.

In the government’s view that the power should only be exercised if a de facto monopoly exists and that the party holding that de facto monopoly has or appears to have set retail prices that result in it obtaining a monopoly rent (Hansard, Parliament of Victoria, Legislative Council: 1415).

This speech was preceded by earlier debate in the Legislative Assembly on 24 May in which government Member for Darebin North North, John Lenders, said:

Another feather in the government’s cap is the creation through the bill of fundamental consumer protection rights for domestic and small business consumers. The bill will put in place a supplier of last resort scheme to ensure that ultimately there is always a retailer from whom electricity can be bought. These are important features of the legislation. The bill also places obligations on electricity retailers to perform community services and provides for deemed contractors to carry over domestic and small business customers from January 2001 (Hansard, Parliament of Victoria, Legislative Assembly: 1713).

The mechanism is designed to provide choice, there is a belief that market competition. The Sale and Supply Code in its new form is called the Retail Code. Other wider regulatory decisions are contained within the Minimum Standards Framework for Full Retail Competition (Minimum Standards).

Part of the revision has been an assumption that monopoly provision requires a more prescriptive consumer protection framework than when competition exists. As markets provide choice, there is a belief that market discipline will prevent market abuse. Hence, the Minimum Standards incorporate a view that retailers and customers should be able to negotiate some aspects of the supply/consumption relationship. Retailers require ‘regulatory space’ to innovate, and customers will display their preferences by willingly exchanging certain protections in order to secure an alternative (and presumably better) benefit.

In providing the opportunity to innovate, the Minimum Standards framework does not merely permit redlining, but actually provides an institutional framework in which it is encouraged. The following tables describe the clauses that establish such a framework.

<table>
<thead>
<tr>
<th>Provision</th>
<th>Requirement: full retail competition</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.3.4 Graphs</td>
<td>The existing standard to display a graphical illustration of a customer’s consumption will be retained, but customers can vary this range of choices through the bill, which will make provision for both those and other matters too.</td>
<td>Retailers will be able to encourage customers onto market contracts by offering a discounted price for omitting the consumption graph. Graphs not only allow the customer to manage their consumption, but provide a wider benefit in terms of demand management and greenhouse gas reductions.</td>
</tr>
<tr>
<td>5.1.1 Issuing of bills</td>
<td>The three-monthly cycle should be maintained for FLC, with customers able to vary this cycle by agreement with their retailers when under direct contract, as long as explicit informed consent has been given. Deemed customers who currently receive monthly bills should remain on monthly bills.</td>
<td>ORG’s usage of ‘explicit informed consent’ has been roundly criticised because it does not really mean explicit or informed, merely that the customer accepts the conditions. Within strictly speaking not necessarily a redlining provision, it may act to radically disempower certain customers. Retailers will be able to issue bills (as an example) once a year but direct debit more frequently. It is a likely tactic for dealing with low income households who may trade off receiving regular bills for some discount, but may find themselves with little practical control over payment or consumption.</td>
</tr>
<tr>
<td>5.3 Payment methods</td>
<td>As basic terms and conditions, customers must have the payment options of mail, direct debit and cash payment at a network of agencies or outlets. No transaction fees will be permitted for over the counter payments. Customers may be able to vary this range of choices through the bill, which will make provision for both those and other matters too.</td>
<td>The cheapest payment options are those predominately available to affluent and educated households (e.g. internet). The second part of this clause in effect permits ‘user pays’. As the number of people paying by a particular method declines, the cost per transaction grows (a common problem in retail markets). It is not difficult to see pressure from retailers to charge for over the counter payments. The aged are especially vulnerable if this were to happen.</td>
</tr>
<tr>
<td>6.4 Assessment of capacity to pay</td>
<td>Retailers will be required to: • Ensure timely assessment of capacity to pay; • Seek assistance from financial counsellors if they are unable to adequately assess capacity to pay; and • Document formal procedures on capacity to pay which is available to customers on request. Customers will be required to advise retailers when they experience payment difficulties.</td>
<td>Such clauses do not address fuel poverty issues. Unless there is recognition that payment must be based on the customers’ capacity to pay and involve the potential for debt forgiveness, as well as retrofitting (to address the likely cause of problems), this clause is meaningless. Both price and consumption contribute to customers getting into debt and arrears.</td>
</tr>
</tbody>
</table>

The ORG was required by Sections 169A and 169B of the Electricity Industry Acts (Amendment) Act 2000 to develop the terms and conditions of supply for the deemed and standing offer customers. In addition, it has undertaken to develop the broader consumer protection framework for small business and residential consumers, including a revision of the former Sale and Supply Code in order to make the provisions technically applicable to full competition. The Sale and Supply Code in its new form is called the Retail Code. Other wider regulatory decisions are contained within the Minimum Standards Framework for Full Retail Competition (Minimum Standards).
5.1 To what extent should retailers be obliged to publish all prices?

All retailers should be required to publish their Standard and Default Tariffs in the Government Gazette under Section 35 of the Electricity Industry Act 2000. Retailers should be permitted to offer wider selection of tariffs tailored to individual customer groups without a requirement to publish these. For published tariffs, retailers should include sufficient information, e.g. breakdown of the component charges, to allow a customer to calculate total cost given their consumption level/system.

Direct debt removes the discretion to choose between competing financial demands. Moreover, lack of control over timing places considerable risk of bank dishonour fees on the account holder. Cost per user of the ‘old fashioned’ system rises as fewer customers use it (an increasingly expensive residual market). After a period it is likely to be abandoned for cost reasons, forcing all customers into the ‘modern’ system - a regime that does not necessarily meet their needs. Besides issues of accountability in adoption of highly automated systems (One-Tel is a relevant example where direct debits continued after the company’s collapse), new technologies are capable of delivering efficiency gains, but this particular innovation is most suited to customer groups that are well off, educated and internet literate. For customers who need longer collection cycles because of small disposable incomes or who want to pay over the counter because it is what they understand, a premium will effectively be charged to have this option. Discounting of certain payment methods introduces additional complications.

5.2 Which customers should be protected by an obligation to publish all prices?

Once all customers have a choice of retail, the obligation to offer terms of supply should apply to all customers below 160 MWh. ORG will consider whether it is appropriate to roll back the application of this obligation once it considers competition to be fully established, and will provide advice to the government in this regard.

This obligation is also currently subject to a sunset clause of 31 December 2003.

5.3 What ability should retailers have to negotiate against the published tariffs?

Retailers should not be prevented from reducing the price of their Default or Standing Tariffs to meet competition. However, ORG does not believe that retailers should be allowed to charge different prices to different customers for tariffs incorporating exactly the same terms and conditions. This would not preclude retailers from developing a range of Standard or Market Tariffs incorporating different terms and conditions at varying prices.

5.4 Which customers should be protected by the obligation to publish prices?

All customers in the <160 MWh/year tranche. ORG will also consider, however, whether it is appropriate to roll back the application of the obligation once it considers competition to be fully established.

Markets only function properly when the customers have perfect knowledge. If there is no obligation to publish any prices and it is difficult to obtain pricing information, there is a clear potential for market abuse.

Table 5: ORG Electricity Retail Competition for Small Customers Position Paper: Obligation to Offer Terms of Supply, Default Retailer and Price Information Disclosure, November 2000 (excerpt of provisions)

<table>
<thead>
<tr>
<th>Provision</th>
<th>Requirement: full retail competition</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1 Which retailers have an obligation to offer?</td>
<td>There should be a general obligation applying to all retailers to offer terms of supply on request within their licensed supply area (i.e. the state of Victoria). But, as an interim measure, no obligation for second-tier retailers to offer terms of supply to customers using below 160 MWh from 1 January 2003.</td>
<td>This clause allows non-host retailers to cherry-pick the more affluent customers and increases the likelihood of residual (power) businesses being captive to their host retailer - thus subject to monopoly pricing.</td>
</tr>
<tr>
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<td>Only the deemed contracts and standing offers are required to be published. The lack of obligation for market contracts to be published denies the customer the opportunity to know the market clearing price. The very existence of undisclosed prices and customer specific offers is a nullifying provision. It allows retailers to choose their customers, rather than allowing the customer to accept a generally offered deal.</td>
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<td>Having a disclosed standing offer and an undisclosed market contract is the mechanism that permits redlining. Retailers can tailor tariffs to the customers they want (they are under no obligation to offer market contracts). Customers they do not want can be relegated to the more expensive standing offers.</td>
</tr>
</tbody>
</table>

Table 6: ORG Draft Electricity Customer Transfer Code, 17 August 2001 (excerpt of provisions)

| 5.1 valid objections on the ground of certified debt held by the retailer | Must be aggregated debt of more than $200, not be in dispute, be outstanding for at least 40 business days, customers have been offered restructuring payment terms; and other debt for which restructured payment terms have been agreed to and adhered to for at least three months. | This provision recognises that blocking transfer, and hence the possibility of a customer accessing a cheaper price, is a major impediment for vulnerable customers participating in the market. However, like the Retail Code itself, the restructuring payment option fails to be defined in terms of what is affordable to the customer. This provision is likely to mean that the most vulnerable are locked into their existing retailer or are denied supply. |

(a) The Office must monitor the licensee’s compliance with the customer-related standards, procedures, policies and practices developed by the licensee in accordance with the conditions; and
(b) if the Office considers that any of the customer-related standards, procedures, policies and practices, or compliance by the licensee with any of them, disadvantages, or may disadvantage any class of its customers, or all of its customers, the Office may make a determination requiring the licensee to modify or revoke any part of the standards, procedures, policies or practices.

Sections (a) and (b) appear to impose upon the ORG an obligation to identify and remedy disadvantage. The redlining provisions of the Minimum Standards, however, mean the ORG will permit licensees to engage in such discrimination. The generic nature of the government’s statements in regard to their legislation does help us to interpret this clause.

It is also difficult to see how the standing offers do not conflict with the objectives of the proposed Essential Services Commission (ESC). Objective (1) states:

In performing its functions and exercising its powers, the primary objective of the Commission is to protect the interests of Victorian consumers with regard to price, quality and reliability of essential services.

And (2) states:

...the Commission must have regard to the following facilitating objectives:...
(1) to ensure that users and consumers (including low income or vulnerable customers) benefit from the gains from competition and efficiency.

However, the ESC legislation is to be subervient to the Electricity Industry Act 2000, if there is any conflict between the two, it...
US states has been a lack of competition, primarily because of the safety net tariffs being set too low. Rosen, Swersson and Stutz (2000) cite the Pennsylvania default provider service being priced without the inclusion of retail costs, and how this has deterred competition from alternative providers. Some states auctioned small customers in an effort to deliver universal service whilst maintaining some kind of competitive pressure. Consumer advocates are concerned that these prices reflect loss-leading bids intended to deter new entrants, and fear the eventual consequences of lack of competition (Patrick 1998).

The Pricing Reference currently being undertaken by the ORG is considering of what the order the headroom should be. The exercise is one in which the market price must be identified, and then a premium over and above that agreed upon. The standing offer, therefore, is a state sanctioned monopoly price that discriminates against those customers who are unable or unwilling to move onto market contracts. The government has, in effect redistributed all residential and small business customers. It does for the retailers what would have taken them several years perhaps to achieve. The existence of monopoly priced standing offers at the outset of competition, moreover, provides the scope for price cuts to be delivered to the most attractive customers. Such price cuts will be acclaimed as successful competition.

How the ORG’s inquiry is supposed to reconcile the stipulation in the Terms of Reference for the Special Reference that the standing offer tariffs must prevent market abuse (monopoly pricing), when by definition standing offers are monopoly prices, is an indication of poor policy formulation.

The customers who are likely to be adversely affected are those with low consumption, low income, poor payment history, pre-existing debt, in rural localities, living in poor housing stock, and tenants (both public and private). Lack of competition will mean retailers will have an effective monopoly over these customers. Standing offers will mean a decline in affordability, and reduced access to supply as households will be unable to accept the offer at the price at which it is tendered. There will also be an increased burden on social services in terms of increased demand for emergency relief and with the health and social consequences of households going without supply.

The approach of most jurisdictions in the United States that have opened competition to households is significantly different to Victoria’s. By and large, they priced the default tariff at the wholesale energy price, effectively undermining competition. A number of observers noted that there is a political interest in delivering price cuts to ease the way for deregulation (Alexander 2001; Rosen, Swersson and Stutz 2000). A default tariff at a discount price was broadly accepted by consumer advocates. The only attempt to introduce a default tariff above competitive rates was ‘roundly criticized and withdrawn’ (Alexander 2001). Despite the ‘protection’ provided by these tariffs, most states have consequently faced decisions about raising prices in response to wholesale market pressures. Alexander concluded that ‘default pools’ as residual markets diminish the capacity to deliver reasonably priced service to their customers and (keeping in mind that she advocates anti-redlining provisions in the consumer protection framework) that:

- If you believe that the prime imperative that must govern the decisions surrounding the implementation of retail competition is the need to create a competitive market as soon as possible, Default Service is a tool that should be wielded to achieve that end.
- If you believe that the competitive market is unlikely to develop in the near future or when developed, is likely to result in higher prices and unstable prices for residual customers, Default Service is viewed as a tool to maintain important consumer protections and maintain the longstanding acceptance of the universal service aspects of basic electricity service for residential and low income consumers.

Disregarding the imperatives behind the default service, she notes that, as the vast majority of US residential consumers have opted not to enter into the market, the ‘Default Service decisions have [therefore] been the primary factor in determining the price and identity of the provider of basic electric service for the overwhelming number of customers in states that have implemented retail electric competition’.

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The Power Exchange is not – as some revisionists have recently argued – the competitive market that Californians were promised for their $30 billion in 1996. It was created as a backup system for the unprofitable consumers (hence the term ‘default service’), much as many states have created property insurance redlining pools for poor people in high risk neighborhoods who often cannot find an insurer who will offer them coverage. The fact that this redlining pool includes 95% of Californians does not make it a market.

Fenn identifies one of the key problems with default suppliers, that being the inappropriate allocation of risk onto the customer.

Community Choice offers significant consumer security against fluctuations in wholesale power prices by transferring the risk to the private sector rather than to the consumers. In the Cape Light’s power supply contract the winning bidder was required to provide performance bonds that are left in escrow in case the power supply is in default of contract. Under the agreement, if the supplier pulls out of a contract and the Comptact must find a new supplier at a new price, the bonded supplier must pay the difference. In this way, Community Choice offers a method of assigning risk to the private sector where it belongs.

Many US states have deferred or stopped full competition on the basis that wholesale market problems cannot deliver the required stability and price constraint required for political acceptance by the residential sector. When the Victorian government introduced the standing offers, such little explanation accompanied it that it is only possible to provide conjecture as to why they thought it was a necessary measure. It is impossible to refer from the speeches of Mr Lenders and Ms Ronan’s that a fear existed that not all customers would be able to access supply in a market situation. The ORG (2000a: 11), in interpreting the government’s intention, suggested:

It must be recognized that not all customers will be equally attractive to competing retailers; therefore there is a need to ensure that those customers who for whatever reason, are less commercially attractive to retailers, are protected by having access to supply on reasonable terms and conditions.

Despite what appears here to be an explicit recognition of the inherent discrimination that occurs in markets and the need to protect vulnerable customers, the subsequent formal position (ORG 2000b) adopted at best fails to understand how such discrimination would operate and at worst repudiates the earlier view. The framework that has resulted contains many measures that do not merely permit the market to operate in a discriminatory fashion, but enable and legitimise redlining. The standing offers, following Fenn’s analysis of California, put all the small customers into the redlining pool at the outset.

Without the standing offer obligation, retailers would have the choice to rid themselves of these ‘hard to serve’ or marginal profit customers entirely. The provision ends on 31 December 2003. From 2004, retailers will be able to refuse to supply households. In New Zealand, where full competition has already commenced, David Russell (2001). Chief Executive of the Consumers Institute, reported the fall-out of recent high wholesale prices on unhedged retailers: ‘One company in particular, has been, without compassion, disconnecting residential consumers who are behind with their payments, making it clear that they do not want them as customers again in the future’. Faced with the stark choice of not being supplied at all, many customers will be forced into contracts that exploit them. Firms will seek to allocate costs onto the less competitive

Section 158AA of the Electricity Industry Acts (Amendment) Act 2000 provides the government with the right to intervene and set retail prices for the deemed contracts and the standing offers. These deemed contracts and the standing offers commenced on 1 January 2001 with prices (as a consequence of not being over-ridden) which can be said to have been approved by the government (ORG 2001a). The prices were in line with the previous MUT, with the exception of Citipower who delivered cuts of approximately 6 per cent. The government did not release any guidelines circumventing the conditions for the use of this reserve power in the parliamentary debate, the potential for monopoly pricing as a result of a lack of competition in the early period of contestability was mentioned. The desire to maintain prices in line with the MUT was cited in a number of speeches.

By June 2001, three host retailers had sought to raise their deemed contracts/standing offer tariffs. Citipower sought to bring its price back up to the MUT, while TXU and Origin sought increases above it.

The government was forced to address the issue of process in the exercise of the reserve pricing powers. It refused the three requests to the ORG for advice under the Special Reference provision (Section 34A) of the Electricity Industry Act 2000, with further instructions to develop general guidelines for retail pricing.

It became rapidly apparent that the deemed contracts/standing offers are, by definition, set at rates that are above the likely market price. The government and the retailers are concerned that without adequate ‘headroom’ between the cost of supply and the deemed contracts and standing offers, there would be little incentive for retailers to offer lower prices. If they are set too close to the market price, customers will not switch. This would mean consumers would forego the efficiency dividends that are said to be created through competition. The experience of many...
customer segments in favour of the more competitive customer segments where they can. Where the purchase is non-discretionary such as with electricity, this strategy is not just possible, but probable.

In markets, retailers seek to increase the margin per customer. They may make a healthy profit from dealing with affluent customers, but the overall rate of return will be less if they have too many low return customers on their books. A retailer could introduce a policy, for example, that they will not offer supply to customers holding a health care card, based on the assumption that people on limited incomes will not use much electricity and will not have the disposal income to purchase other products the retailer may be seeking to sell. Or a retailer may not wish to supply customers living in public housing because they regard such customers as a credit risk. People living in rural areas may find there is little competition because of the overhead costs involved in servicing a small number of customers over a vast territory.

The state of New York Public Services Commission (2001: 52-65), in grappling with the notion of a ‘provider of last resort’, concluded that with sufficiently robust competition this would not be needed. Despite this, the Commission acknowledged that, unless the law imposes an obligation to serve all customers, some customers would not be served. It argued further that ‘the greater concern is the price a poor customer would have to pay to receive service from the market’.

The Commission regarded rational economic discrimination (providing price signals for load management) as allowable, but discrimination based on the customer’s income ‘should not be permitted for the supply of these essential services’. It was basically saying that a vulnerable customer’s lack of economic power should not be exploited. The Commission also discussed the problem of creating residual markets to supply vulnerable customers as these spread the cost of supply over a smaller customer base, effectively lifting the cost of supply to each customer in that residual market.

The experience of the FAIR law enacted by the US Congress to counter discriminatory property insurance practices is valuable to the current debate. Colton (2000) explains that, after urban rioting in the 1960s, property insurers withdrew from inner urban neighbourhoods. The FAIR law resulted in insurers covering customers with good profile and leaving the rest to a residual public market. This public market offered less insurance coverage at higher rates:

> ‘It was widely believed that the FAIR plans would make insurance available to all insurable risks. Regrettably, this did not come to pass...Denied coverage in the voluntary [private] market for whatever reasons, rejected applicants found themselves paying appreciably higher premiums for less coverage. Some of the plan’s rate were over three times those of the voluntary market with the result that risks often were “written out” by the voluntary market and then “rated out” by FAIR plans.’

In Victoria, the monopoly distribution systems or ‘poles and wires’ businesses are regulated (by the ORG) because competition is not practically possible. In a post-reform environment it is distribution, rather than generation or retailing, which most reflects traditional pricing practices. It is important to understand the traditional thinking in regard to the allocation of costs on customer classes and the resulting pricing structures in order to understand some of the assumptions that underpin price discrimination and, subsequent to disaggregation, why these assumptions must be revisited.

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The traditional view is that small customers require extensive infrastructure to serve them and that each customer (consuming relatively little) therefore returns only a small margin on this investment. In contrast, large customers require far less extensive infrastructure and provide greater margins. This is illustrated by the fact that there are only around 17,000 contestable (large) electricity customers in the entire NEM who represent about 60 per cent of the total demand for electricity. In Victoria alone there are around two million small business and residential customers who account for less than 40 per cent of the state’s demand. It is assumed that, if all customers paid the same price, this would involve a cross-subsidy from large users to small users. Utilities as a consequence have engaged in ‘Ramsey pricing’ which involves marking up the prices (that is, adding a premium) to those customer classes which display the least elasticity of demand. In other words, residential prices are set at a higher rate than tariffs for larger customers because households can do little but pay and are unlikely to alter their consumption in response. In the context of state ownership of utilities, governments balanced the interests of large customers wanting cheaper electricity and the political consequences of rating domestic tariffs too highly. In Victoria this has meant that domestic prices have been higher than industrial and commercial tariffs, but within bounds acceptable to the community.

It has been argued in the Victorian electricity distribution pricing review and more generally that retailers and distributors need the flexibility to ‘rebalance’ their tariffs to make them more cost reflective. Cost reflectivity or ‘user pays’ is a cornerstone of neoliberal economic thinking as it presumes customers need the correct pricing signal in order for the market to achieve the most efficient allocation of resources. In concrete terms, this means that a customer may choose differently between two locations if the price they paid for electricity reflected the difference in the cost of supply to each location, or a customer may choose to run machines at different times as the cost of supply varies over the day, week or season.

Three central issues emerge. Firstly, is the assumption about which customers contribute to what costs correct? Secondly, what are the implications of assigning (or reassigning) costs to particular customer classes? The third involves other cost variables such as location.

As Australian consumer rights advocate Lisa Carver (1995: 19) noted:

1) The various methodologies available for quantifying costs of production are highly arbitrary (e.g. marginal and avoidable costs, fully distributed costs and stand alone costs), and
2) The discretion inherent in how pricing may be composed (e.g. the use of marginal cost pricing in volumetric usage and access and minimum charges to recover capital costs) can have a dramatic effect upon equity of access. Further the potential for discrimination between classes of consumers (e.g. Ramsey pricing) and regressive pricing packages in the exercise of discretion is considerable.

Colton (1996) distinguishes between the contribution low income households make to cost of supply and the general demand cost profile. He challenges the assumption that domestic users as a whole are in receipt of subsidies from non-domestic users. The subsidies flow, he says, from low income users to affluent residential customers. Because poorer customers generally do not have appliances such as air conditioners, they are penalised by being forced to pay prices that reflect the cost air conditioning imposes on the electricity system at peak times. Growth in demand from the less well-off customer segment is less than in the more affluent segments of the residential class. This means that poorer customers are paying for new capacity that is not justified by their consumption patterns. Colton argues that, as low
Standing charges support marketing mandates that far as these differences reflect reasonable guidance issued by the Secretary of State in respect of social and environmental issues; and 

Standing charges tend to collect disproportionately more revenue from low income consumers than the costs these customers impose on the network; and 

Lowest income households use, on average, less electricity than other consumers and pay higher prices with a standing charge (Pareto Associates 2000: 5).

The Pareto report was scathing in regard to the ORG’s approach to pricing principles, describing its faith in regard to DBs behaving reasonably within the economic incentives provided as ‘naïve’. It concluded that, without explicit policy constraints, ‘unfair price discrimination’ would occur and tariffs would not be ‘aimed at cost-reflectivity’, rather that the DBs will behave as the monopolists they are...the DBs can be expected to [sic] everything within their power to optimise any opportunities they find to appropriate monopoly rent including, setting anti-competitive tariffs, setting upper and lower bounds on tariff [sic] that are not consistent with economic efficient principles and practising unfair price discrimination (Pareto Associates 2000: 35).

Discrimination: A Cost Structure Issue?

Economist and low income advocate Eugene Coyle argues that economic discrimination between classes of customers is fundamental to the recovery of costs in industries such as electricity. In Price Discrimination, Electric Redlining, and Price Fixing in Deregulated Electric Power, he points to the history of undifferentiated commodity markets in the United States that demonstrate cooperation rather than competition has maintained profits in these industries, including electricity. Secondly, he says that large overhead costs put pressure on plants to practise ‘yield management’.

Victoria has adopted the use of a ‘tariff basket’ approach to setting of distribution tariffs. The ORG imposes an ‘X’ factor (being a price cut in percentage terms) to the total of the tariffs, that is, to the ‘basket’ as opposed to each individual tariff. It is left up to the DBs how they wish to allocate the price cut explicit in the ‘X’ to each customer class (tariff). The 2001 Electricity Distribution Price Review by the ORG determined that an ‘X’ factor of 12 to 22 per cent apply to the tariff basket (depending on which DB) in the first year of the regulatory period (2001) and 1 per cent in each of the subsequent years of the regulatory period (2002 to 2005) for each DB. That is, the ORG mandated a price cut (after an adjustment for inflation) of 12 per cent across the board in the first year and of 1 per cent in each subsequent year. So long as there is a total price cut of 12 per cent (or 22 per cent, depending on which DB) in 2001, the ORG is not concerned about which customer are the recipients. In effect, it allows for domestic tariffs to fit by the rate of inflation, while other users receive cuts of 12 per cent. The tariff basket approach is ostensibly to allow the rebalancing of tariffs.

The only constraints imposed were that each tariff should represent a point between ‘avoided cost’ (the amount the business would save if it did not serve that customer class) and ‘stand-alone’ costs (the amount it would cost if the business only served that particular customer class). As the table below demonstrates, there is a huge difference between the boundaries and between the cost allocated to each customer class.

The other constraint was that rebalancing (increases) should be smoothed over a number of years, avoiding price shock for the customers involved. This approach provides the DBs with tremendous scope to tariff rebalancing even within the constraint of the ‘X’ cut to the tariff basket.

As Victorian home occupancy is close to 100 per cent and as people do not choose where to live on the basis of electricity prices, it is rational for the DB to load costs onto the residential class in favour of their larger customers who can relocate and have a stronger interest in electricity prices. Only time will tell if this is the case, but the imposition of an effective price cap on residential retail prices as a result of the deemed/standing offers is possibly constraining rebalancing of distribution tariffs for the moment. However, the view that residential customers may be more profitable than frequently assumed is supported by credit rating agency Fitch (2000) who highlighted one of their regular market updates the significance of the domestic sector for distribution profits.

The Energy Action Group was critical of the 2001 Electricity Distribution Price Review Determination because it allowed discriminatory pricing and concluded that households would receive fair and reasonable prices. In addition, the methodology embedded substantial air conditioning cross-subsidies that harm low income households. Consumer groups were also critical of high standing charges. Jeff Washusen of Pareto Associates, a consultancy engaged by the ORG on behalf of small electricity consumers, noted the impact of standing charges on equity:
Proponents of deregulation and competition argue strenuously that it is highly desirable to obtain price signals based on the system marginal cost as this is the means to the most efficient allocation of resources. Coyle disputes this view that competition will mean utilities will price output at the system marginal price, because to do so would bankrupt them. This view is supported by OFGEM (2003b) in relation to distribution networks. Coyle (2000: 30) says that utilities traditionally do not price on the basis of marginal cost but engage in Ramsey pricing, which is difficult to distinguish from simple monopoly pricing, where the profit maximizing rule is to squeeze each customer for the maximum revenue possible.

Coyle (2000: xi) maintains that it is essential to understand the cost structure of the industry itself, and that it is no longer tied to a capital intensive market but that the service is inherently discriminatory towards them (Klinger 1998). Because much fuel poverty in Victoria derives from poor housing quality, they are penalised when they may otherwise cope. By allowing double discrimination, we are encompassing the poverty and removing their remedy to the situation. The ‘investment’ customer is required to make in obtaining electricity should in part be going to fix the housing quality. It is economically inefficient to allow this mismatch of investment need to investment capacity.

The New Jersey Board of Public Utility Control (n.d.) has explicitly provided for anti-discrimination and anti-discrimination measures in its Interim Retail Choice Consumer Protection Standards for electricity competition:

Redlining means a procedure which involves unreasonable discrimination based upon race, color, national origin, age, gender, religion, source of income, receipt of public benefits, family status, sexual preference, or geographical location.

In doing so, the New Jersey Board of Public Utility Control (1997) also acknowledged the distinction between the opportunity and the actuality of obtaining benefits from competition. However, as Coyle (2000) notes, governments may recognise economic redlining as a problem, but they are failing to understand the distinction between active exclusion and omission.

The following three scenarios describe why redlining is problematic and broader than welfare.

**Case 1**

In terms of retail costs, low income customers may cost more (they may need to negotiate more often with a customer services officer, or pay more frequently over the counter), but this is because the service is inherently discriminatory towards them (Klinger 1998). Because much fuel poverty in Victoria derives from poor housing quality, they are penalised when they may otherwise cope. By allowing double discrimination, we are encompassing the poverty and removing their remedy to the situation. The ‘investment’ customer is required to make in obtaining electricity should in part be going to fix the housing quality. It is economically inefficient to allow this mismatch of investment need to investment capacity.

The ORG assumes that tariff redlining will only occur to the extent that prices will reflect the contribution the customer makes to costs, but this is manifestly wrong. How generators will recover their costs is beyond the scope of this paper. However, Coyle (2000) argues that there will be price wars and then corrections involving mergers and collusion in order to support the ‘correct’ amount of capacity. Such a wave of mergers has already taken place in the United Kingdom (Unison 2001) and is even underway in the United States, despite the recently mandated retail restructuring legislation in each state.

The Victorian industry is already experiencing its first wave of reintegration (each of the three planned gas fired power stations involves retailers and generators as owners) and increases in horizontal market power (permitted by the recent relaxation of the cross-ownership provisions in the Electricity Industry Act 2003).
5.5 CUSTOMER INERTIA?

ConSUMER inertia is a common problem even if there is a robust competitive market. The experience in the United States for both gas and electricity is the extent to which energy companies actually compete in the residential market. Successful markets have many competing firms and the threat of new entrants provides discipline on prices and service. The decision by a potential new competitor to enter will depend on assessment of the likely profits (rate of return) and the period over which investment can be recovered. If potential competitors do not materialise, that leaves incumbent firms with significant market power.

Coyle (2000) believes that the high cost of acquiring small business and residential customers and the low rate of return increases the need to discriminate between affiliated customers to whom bundled products can be targeted and low income, low consumption households who are to be avoided. This, he says, can be achieved via data mining technologies and the substantial lack of personal privacy. Moreover, new technologies such as the internet, which in terms of personal use correlate heavily with affluent households, provide a remarkable tool for such discrimination. The internet also provides a possibility for overcoming some reasons for discrimination, such as the geographical disadvantage experienced by rural and remote customers, but this depends on access to equitable telecommunications services which is subject to similar discriminatory strategies.

Either lack of competition or customer inertia provides incumbent firms with the market power. An effective monopoly allows prices for captive customers to be subject to undue price increases. Rosen, Svensson and Stutz (2000: 56-7) state:

When price discrimination is not based on the willingness to pay but, rather, on the customers’ inability to negotiate the terms of the sales contract, or some other manifestations of market power that turns a particular customer class into price takers, particularly for a necessity of life, then it is clear that price discrimination has taken a negative turn. It is also clear that such price discrimination is likely to hurt small customers, while large customers are likely to benefit [author’s emphasis].

Sixth, market barriers exist that impede maximizing benefits would nonetheless still yield small gains.

Third, market barriers exist that impede customer participation in the competitive market. These barriers include high information and transaction costs, the uncertainties involved with making assessments, and the efforts needed to be expended to switch providers.

International experience has seen very low ‘ churn’ (customers changing retailers) rates in most jurisdictions where full competition has occurred. Colton (1998) cites work undertaken by the US General Accounting Office which reports that only about 4 per cent of small gas customers had opted for a new retailer. Baker (2001) reports United Kingdom churn rates are higher but related to the take-up of dual fuel deals. However, low income customers were actually paying more for fuel purchased dually than if they had purchased each separately, which reflects marketing strategies and poor consumer awareness. Union (2001) question the ability and incentive for small customers to switch, citing possible savings of as little as £5 per year.

Consumer inertia is clearly an issue even if there is a robust competitive market. The experience in the United States for both gas and electricity is the extent to which energy companies actually compete in the residential market. Successful markets have many competing firms and the threat of new entrants provides discipline on prices and service. The decision by a potential new competitor to enter will depend on assessment of the likely profits (rate of return) and the period over which investment can be recovered. If potential competitors do not materialise, that leaves incumbent firms with significant market power.

Work by Costello (quoted in Colton 1999) revealed that the cost of acquiring residential gas customer was £200, while the margin per annus was £25 over an eight year payback period. Enron, the world’s largest energy trading company, pulled out of residential gas retailing in the United States, citing profit margins as being too low. After surveying the field of electric providers on the eve of the opening of the Californian market, UCAN (1998) found that ‘few legitimate businesses are interested in entering the small business or residential market’. The cost of acquiring residential consumers was also expensive for Enron when this market opened, reflecting experiences in other markets such as New Zealand.

Coyle (2000) believes that the high cost of acquiring small business and residential customers and the low rate of return increases the need to discriminate between affiliated customers to whom bundled products can be targeted and low income, low consumption households who are to be avoided. This, he says, can be achieved via data mining technologies and the substantial lack of personal privacy. Moreover, new technologies such as the internet, which in terms of personal use correlate heavily with affluent households, provide a remarkable tool for such discrimination. The internet also provides a possibility for overcoming some reasons for discrimination, such as the geographical disadvantage experienced by rural and remote customers, but this depends on access to equitable telecommunications services which is subject to similar discriminatory strategies.

Either lack of competition or customer inertia provides incumbent firms with the market power. An effective monopoly allows prices for captive customers to be subject to undue price increases. Rosen, Svensson and Stutz (2000: 56-7) state:

When price discrimination is not based on the willingness to pay but, rather, on the customers’ inability to negotiate the terms of the sales contract, or some other manifestations of market power that turns a particular customer class into price takers, particularly for a necessity of life, then it is clear that price discrimination has taken a negative turn. It is also clear that such price discrimination is likely to hurt small customers, while large customers are likely to benefit [author’s emphasis].

Stutz, quoted in Colton (1999: 36), warns that small customers face the risk of ‘cost-shifting and lack of market power’ (that) will result in small captive customer rates increasing. He makes the comment that existing programs, many of which do not afford adequate consumer protection ‘would need to be strengthened and expanded’. Fear of cost shifting, price discrimination and market failure were central to the Consumer Union / Consumers Federation of America 1998 report, The Residential Ratepayer Economics of Electric Utility Restructuring: Balancing All the Costs and Benefits.

The move from universal service to markets has also been identified as resulting in the withdrawal of services from particular regions. The University of Newcastle upon Tyne (2000) report, The Residential Ratepayer Economics of Electric Utility Restructuring: Balancing All the Costs and Benefits, states: ‘the willingness to pay but, rather, on the customers’ inability to negotiate the terms of the sales contract, or some other manifestations of market power that turns a particular customer class into price takers, particularly for a necessity of life, then it is clear that price discrimination has taken a negative turn. It is also clear that such price discrimination is likely to hurt small customers, while large customers are likely to benefit [author’s emphasis].

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The Redlining of Vulnerable Electricity Customers in Victoria

As its principal objective, OFGEM is required by Section 9 Part 4AA of the Act to protect the interests of consumers, having regard to:

• Individuals who are disabled or chronically sick;
• Individuals of pensionable age;
• Individuals with low incomes; and
• Individuals residing in rural areas.

The Utilities Act 2000 and the subsequent Social Action Plan developed by OFGEM is not without critics. National Energy Action (NEA) (2001) point out that much is being left to interpretation; that, despite the legal obligation to supply, insufficient guidance is provided to protect vulnerable households from disconnection; that programs are too narrowly targeted; and that energy efficiency measures need to be directed towards all consumers. In its Response to the United Kingdom Fuel Poverty Strategy Consultation,
The second study, Competitive Energy Markets and Low Income Consumers by Baker (2001), involved a three-year longitudinal survey of the experience of low-income households in the competitive energy markets. Commissioned by the National Right to Fuel Campaign and the Centre for Sustainable Energy, it found that many people had been lifted out of "marginal fuel poverty" as a direct result of lower prices (acknowledging that gas input prices had declined substantially over the period), but that the number in severe fuel poverty had actually increased.

Baker (2001: 8) noted that:

New suppliers were continuing to 'cherry-pick' the more affluent consumer.

Most companies were competing on price for certain consumer groups, primarily Direct Debit payers, rather than 'added value' services. Special services to vulnerable groups, such as disabled and pensioner households, were not improving.

The study referred to this disparity as 'uneven development'. This is characteristic of economic discrimination or redlining: they [fuel suppliers and OFGEM] argue that Direct Debit consumers are much cheaper to service than prepayment meter and frequent cash payment customers. Competition, encouraged by regulatory action, leads to cost-reflective pricing and the elimination of cross-subsidies. This means that previously 'hidden cross-subsidies' of certain payment options are revealed. Suppliers seek to gain competitive advantage by attracting consumers who pay by more cost-effective payment options. However, these trends exacerbate existing differences between affluent and low-income households since prepayment meter and frequent cash options are more commonly used by low-income households (Baker 2001: 14).

Many full-time workers were found to have switched suppliers, but pensioners and those of ethnic background had not. Many households were not aware of the costs associated with the various payment methods, for example, that pre-payment meters were the most expensive option. The study cited the demand made by suppliers that price controls on pre-payment meters be lifted, arguing that the price cap is too low and the customers are costly to service. In response to the inequity faced by users of these meters, OFGEM (2000a) is seeking greater uptake of other payment methods such as direct debit. In contrast to Australia, many people in the United Kingdom do not have a bank account, and the greatest proportion without accounts are poor. The strategy to introduce no-frills bank accounts and to extend universal banking services at post offices so direct debit can be utilised reflects, from the Australian experience, little awareness that deregulated banking industries discriminate in exactly the same way.

Importantly, the study recommended that energy efficiency investment and advice be integrated with debt management as few people in hard to heat housing reported receiving such advice or help from their energy supplier.

Baker's conclusions are supported by the House of Commons Select Committee on Public Accounts (2000):

(i) A key reason why prepayment meter customers pay higher prices appears to be that price competition amongst gas suppliers for prepayment customers is weaker than in other parts of the market. Of the 21 companies seeking to sell gas to such customers in January 1999, ten offered tariffs costing about the same as British Gas Trading and five had tariffs costing only. Six had tariffs producing a saving, the largest being no more than £18 a year. In contrast, all of the companies that have entered the market since competition was introduced are offering prices for customers using other payment methods that are lower than British Gas Trading's.

(ii) OFGEM want to ensure that the process charged to prepayment meter customers reflect the costs of supplying them, and reviews by OFGEM of these costs have resulted in lower prices for prepayment meter customers.

Approximately 80 per cent of customers using pre-payment meters did so because they owed money to British Gas Trading, which contributed them from switching suppliers:

We are very concerned that... customers using an average amount of gas pay... around 30 per cent more if they pay by a prepayment meter than paying by monthly direct debit.
participants ought to be an objective of the regulatory environment in which utilities operate’. She recommended that a pricing oversight board be established as part of the market reforms taking place, suggesting that such a board must consider the issue of ‘competitive parity’, but should also include:

- Maximum prices that monopolists can change should be set through a transparent and independent process such as a statutory tribunal;
- Legislation must provide explicit criteria for the factors to be taken into account in setting maximum prices;
- Efficiency, equity and ecologically sustainable development should be incorporated into those criteria; and
- Price regulation should promote least-cost planning and demand management as tools for achieving ecologically sustainable development.

Jeanette McHugh (1995), Federal Minister for Consumer Affairs, in her opening address to the Consumer Protection and Utilities Reform seminar, said:

Public utilities…must not discriminate against customers who are suffering financial, physical or geographical disadvantage...these differences and the costs associated with them include:

- Higher prices for energy delivered to customers in remote or sparsely populated areas;
- Higher prices for energy delivered to customers who are low-income or who have limited access to energy services;
- Higher prices for energy delivered to customers who are elderly or who have disabilities.

The Energy Action Group has sought estimates of the IT costs, but none of the official authorities have been willing to make any such analysis public - if indeed any such analysis has been undertaken. On the basis of the publicly known data, the Energy Action Group estimates the implementation and running costs of FRC (on the basis that current retailers operate in each jurisdiction - i.e. that it is a national market) as follows:

- Victoria: $1.5 billion and $4 billion over the next five years.
- Tasmania: $0.5 billion over the next five years.
- South Australia: $0.25 billion over the next five years.
- Western Australia: $0.15 billion over the next five years.

The Energy Action Group estimates that the total cost of implementing FRC in all states and territories will be around $5 billion over the next five years, threatening the retail profit margins on small customers. If FRC costs are combined with the costs of customer switches, the return on investment may be deemed contracts/standing offers on the basis of efficiency, equity and ecologically sustainable development:

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manage during high price periods will be worth up to 1-200 times more to a retailer than a conventionally ‘profitable’ high volume consumer who won’t load manage.

Fenn (2000) also argues that demand responsiveness is a key to protecting small consumers from wholesale price risks. He suggests consumer controlled aggregation, noting the contrast between the incentives for growth in consumption on the part of the industry and the interest of consumers in controlling consumption in order to control prices.

Commodity Choice of public Energy Efficiency and Renewables funds is also critically needed to mainstream existing summer peak-levelling technologies that will continue to remain marginal to the power supply market as long as the state’s wires companies continue to control the badly contested energy efficiency and renewables surcharge funds that are currently collected from every Californian.

The Sacramento Municipal Utility District (2000) in California provides a very recent example of the benefits of load control. It has a program called Voluntary Emergency Peak Corps who agree to have their air conditioning remotely turned off during peak load crises (which have become more frequent) and are rewarded for each load managed.

One hundred thousand customers participated in the program, which enabled delivery of system security to the wider grid on six occasions and also a tenth consecutive price cut at a time when other Californians were experiencing price shocks.

One attraction of interval meters in the context of full retail competition is that the remote meter reading function alleviates the geographical cost differential between customers. Rural customers therefore would start looking more attractive to serve. Whilst electronic handling can marginalise some customers, it is also capable of removing other forms of disadvantage, and geographical disadvantage may be one of them. In order to create an anti-redlining consumer protection framework, it is essential to make retailers ‘blind’ to the location of their customers.

Competition requires the right price signals and the proper allocation of costs. Neither of these conditions are going to be met for FRC.

ANTI-REDLINING STRATEGIES

SAFETY NET ALTERNATIVES?

10.1 ELIMINATING FUEL POVERTY

While markets have been held up as delivering economic efficiency and producing better services to consumers, the fact that they do not treat all consumers equally has rarely received attention from our governments in the Australian and in particular the United Kingdom, and increasing pressure is being brought to bear on Australian governments as consumer disadvantage becomes more apparent. It might be said that the policy preference of governments to eliminate fuel poverty in Victoria.

Electricity prices are not expensive relative to fuel prices and the climate is not extremely cold. Fuel poverty could be easily and fairly cheaply eliminated given a ‘wholesale of government’ approach to the issue. The government currently spends between 55 million and 50 million per annum on energy relief grants and winter energy concessions. The reasons relief addresses in part people’s inaccessibility to pay, but does nothing to alleviate non-income related causes of fuel poverty. In particular, programs to address consumer poverty are not available to all. This is largely due to policies to ensure that, in a number of cases, will preclude any further material assistance by the state. Moreover, there are obvious welfare benefits of the customer being able to increase spending on energy these customers typically self-restrict or offer to an extent, welfare programs will result in the reduction of greenhouse gas emissions. Government can use its welfare spending and environmental mandate to assist vulnerable electricity customers. It can also ensure that the economic regulation of the industry does not encourage increasing consumption, or marginalize those who cannot afford to pay for an adequate level energy or those who invest in energy efficiency. From a market perspective, it will be extremely important for government to ensure that consumers can participate in an exercise in choice in the market and the demand side is capable of influencing market outcomes.

This has engendered a restructuring dynamic in which low profit centres and non-performing areas of these businesses are being identified and removed. It is not possible to move the business away from these areas of low profit without changing service provision, then strategies are being developed to limit exposure to them and increase the contribution these customer segments make. This involves removing explicit and implicit cross-subsidies, imposing higher prices, utilising alternative technologies, seeking government subsidies and reducing service quality. In some cases, ‘captive’ customer segments may afford a business the opportunity to create cross-subsidies going from marginal customer groups to the profit centre of the business.

When David Murray, Chief Executive Officer of the Commonwealth Bank, threatens to dump small customers, he is asserting that the bank will be judged as an investor and not a consumer, but reducing service quality. This policy recognises the requirement for certain infrastructure to be in place and to be accessible to enable industrialisation and other economic development, especially in regional areas; and servicing of low profit customers because it was economically feasible to do so, given the lower rate of return.

It could be said that the policy preference itself for deregulation and privatisation has created an instability for profits that necessitates social and economic exclusion (Köller 1998, citing Teeples). Government and regulators need to thoroughly address market segmentation issues and the implicit rate of return for the utility (in total) and for each market segment. They need to develop regulatory strategies to guarantee social and economic inclusion.

Equity holders, particularly in the share market, have greater expectations of higher rates of return than in previous eras. This change has taken place since the widespread deregulation of the economy. In part this is attributable to the promotion of reform by governments and the private sector. Debt holders, particularly in privatised assets, were in many sale processes given very clear signals about the rate of return that they would be permitted to extract from former government trading enterprises – such expectations being capitalised into the sale price.

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Further, that the discrimination. Ralph Nader that poor tenants are either of poor creditworthiness public housing or cheap private rental. Armed with providers and insurers engaging in redlining. For quantum leap from the days in which zipcodes customers (Coyle 2000; Bowers 2001). It is a and identification intended to exclude or deter a number of uses. This includes selective marketing and potential customers to be developed and put to selectively target consumers, especially in relation to Geographic Information Systems Project analyze data based on locality.

10.2 Market Surveillance

The use of advanced IT to data mine, sort and analyse personal information provides substantial opportunity to utilities seeking to selectively target consumers, especially in relation to bundling of services. It allows profiles of customers and potential customers to be developed and put to a number of uses. This includes selective marketing and identification intended to exclude or deter poorer customers (Coyle 2000; Bowers 2001). It is a quantum leap from the days in which zipcodes were used as identifying tags by credit providers and insurers engaging in redlining. For example, it is possible to identify a street address as public housing or cheap private rental. Armed with such knowledge, the retailer can then refuse to offer anything but the standing offer (on the assumption that poor tenants are either of poor creditworthiness or warrant little attention in terms of bundling of services). However, there are similar technologies that provide the capacity to identify such discrimination. Ralph Nader’s Essential Information’s Geographic Information Systems Project ‘allow(s) traditional database queries to include the ability to analyze data based on locality’. This is used by Essential Information ‘as a tool for advocacy purposes...to analyze a variety of databases highlighting patterns of discrimination’ (Essential Information n.d.).

It is absolutely clear that the creation of residual markets is to be avoided. An alternative is aggregation schemes such as the Community Choice programs proposed by US advocates. These involve the designation of the municipal government as the provider, but permit customers to opt out. The city secures the supply through government as the provider, but permit customers these involve the designation of the municipal government as the provider, but permit customers to opt out. The city secures the supply through the opening of the electricity market to all customers regardless of size.

11. Recommendations

Recommendation 1
That the Victorian government provide for a legal obligation to supply electricity at a fair and reasonable price in amendments to the Electricity Industry Act 2000. Further, that the Essential Services Commission develop and enforce a consumer bill of rights that provides for a prohibition on redlining. Such a bill of rights would include:

- Pricing guidelines providing for non-price discrimination;
- A ‘cap the gap’ principle; and
- Pricing guidelines to remove cross-subsidies for domestic air conditioning.

Recommendation 2
That the Victorian government scrap the standing offer provisions and develop an alternative safety net. This may be a state purchasing pool, especially if it is linked to low income programs. If the standing offers were to be retained, they should be linked to government programs that will work with the customers to reduce their consumption on a permanent level. Such assistance should involve actual retrofits and should not be merely advice. Secondly, the standing charges or service to property charges should be significantly lowered to permit the customer greater discretion over their consumption.

Recommendation 3
That the Victorian government ensure effective demand side response to prices and enable fast and efficient customer transfer process by mandating a mass roll-out of interval metering as a regulated distribution asset.

Recommendation 4
That the NEM jurisdictions quickly address issues of generator gaming (price manipulation), transmission constraints and the growth of ancillary service payments.

Recommendation 5
That the Victorian government adopt a least-cost planning framework for distribution regulation.

Recommendation 6
That extensive publication and promotion of prices and packages be required by legislation. The opening of the market should involve an initial period of standardised packages. Consumers also need to be made aware that there is a distribution price differential.

Recommendation 7
That the ORG undertake extensive market surveillance and reporting, and resources be provided to consumer advocates to undertake their own market reporting.

Recommendation 8
That the Victorian government provide adequate resources to consumer advocacy organisations.

Recommendation 9
That the Victorian government review its own welfare safety net and orientate it towards addressing consumption as a means of increasing affordability and participation in the market.

Recommendation 10
That the Victorian government implement non-price measures (for example, taxation measures, rebates, regulation) for demand management.

Recommendation 11
That the ORG and the Victorian government undertake a review of whether or not bundling of energy services with non-utility products is appropriate.

Recommendation 12
That the ORG initiate a longitudinal study to examine the impact of the market on vulnerable customers and on customers more generally.

Recommendation 13
That individual investors be encouraged to think about whether or not utilities can be regarded as ethical investment if they engage in redlining. Investors should seek to have these companies adopt a social charter that precludes redlining.

Recommendation 14
That the Victorian government adopt a least-cost planning framework for distribution regulation.

Recommendation 15
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References


UCAN 1996. Electric Retail Competition at the Starting Gate: Offering the Worst of What Competition Has to Offer Small Customers (http://www.ucan.org.au/energy/electric_report.html).


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