FIXING UP FIXED TERM CONTRACTS FOR ENERGY CUSTOMERS

YOUR QUESTIONS ANSWERED

What is the proposed reform?

The Consumer Utilities Advocacy Centre (CUAC) is advocating for reform to energy retail regulation to remove the ability of retailers to change the tariff or price for a particular consumer during the term of a fixed term contract. We believe such a reform will benefit both consumers and the energy retail market. This document provides answers to some likely questions about the proposal for the benefit of those with an interest in energy retail market reform.

What is a fixed term contract?

A fixed term contract within the context of CUAC's proposal is a retail energy market offer that is of a fixed length and includes exit fees if the consumer leaves the contract before it expires.

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Is it possible?

Origin Energy's recent introduction of a fixed term contract with prices that are fixed for the duration of the contract indicates that retailers can determine effective prices and contract duration for such products.

In developing this offer, Origin Energy would have to have taken account of distribution prices, wholesale energy costs and the carbon tax for the duration of the contract.

What will the reform mean for consumers?

As a result of the proposed reform, consumers will be able to select fixed term contracts knowing with certainty the price that they will face over the term of that contract will be the price they agreed to at the outset. This will give consumers greater confidence in their choice and will provide more certainty about future energy costs and budgeting. The reform will also overcome the problem, under current market arrangements, whereby a consumer could select the best deal for them at a particular point in time only to find that the price they agreed to is quickly replaced by a new tariff that is both unsuitable and uncompetitive relative to alternative offers. In other words, consumers would no longer confront the risk of unforeseeable price changes that can result in a good offer turning into an uncompetitive offer.

What will the reform mean for retailers?

The proposed reform would remove the ability of retailers to change prices during the course of fixed term contracts and would therefore require them to plan for likely electricity price increases in their tariff setting for fixed term contracts. Under the proposed reform, fixed term contracts would be retained, as would the regulated exit fees for those contracts. This would allow retailers to be relatively certain of the size of their customer base and to plan their pricing strategy accordingly. However, retailers would no longer be able to take advantage of exit fees to raise prices during contract terms. Under current regulatory arrangements, retailers have an incentive to lock consumers in for long contracts (3 years is not unusual) knowing that exit fees will discourage consumer switching even though the retailer can increase prices. The proposed reform would disincentivise such behaviour and would instead encourage more reasonable and efficient contract lengths.

In addition, retailers would have to consider likely cost increases over the length of their fixed term offers and factor them into the price. However, given that retailers are well placed to manage future prices and wholesale market risk they are also well placed to factor these risks into their retail prices. Distribution pricing decisions and regulatory changes are also sufficiently predictable to feature in the setting of prices for fixed term contracts.

What about contracts without fixed terms?

Contracts without fixed terms would continue to be offered. Some of these would be the default standing offer contracts. Prices for these contracts would be varied according to the relevant laws and regulation. Contracts without fixed terms may be preferred by consumers who want the flexibility to change provider as prices and offers change. They may also be preferred by people who simply do not like to be tied to a particular provider.

What happens in other industries?

High exit fees for mortgages coupled with banks increasing their interest rates (prices) above the Reserve Bank of Australia's changes to the overnight cash rate prompted the Commonwealth Government to ban mortgage exit fees. In some cases, these exit fees were thousands of dollars. This reform was widely seen as a competition enhancing reform that encouraged more active consumer search, market engagement and participation. Consumers can now respond actively to price changes and service offerings to find the mortgage that most suits them whenever they like without penalty. The use of a ban on exit fees was more appropriate in the context of mortgage products given that the term of mortgage contracts is usually 25 years and due to the nature of the credit pricing regime. The proposed CUAC reform in the energy market is preferred because of the shorter contract lengths in energy and the fact that many consumers may wish to opt for price certainty for a limited time period.

In telecommunications, the Telecommunications Consumer Protection Code has provisions that generally prevent telecommunications companies from changing prices without also offering customers the option of leaving the contract without penalty. Consumers are generally aware that if they sign up to a 1-2 year mobile phone contract the prices under that contract will remain the same for the duration of the contract. The consumer protection code would require the provider to allow the customer the option of leaving the contract if the retailer unilaterally changed the price. The arrangement in telecommunications is almost equivalent to the proposed reform in the retail energy market.

Is there an alternative approach to achieving the same outcome?

An alternative approach to achieving outcomes similar to that of the proposed reform would be to ban exit fees on fixed term contracts. This would allow consumers to exit a contract during the term of the contract if the prices increased or if they found a better offer. While this would encourage flexibility and active consumer switching, it would remove the option of consumers being able to select a product that offered them price certainty for a fixed period. Similarly it would reduce the ability of retailers to plan effectively and manage risk through the contracting of consumers for a fixed and known period of time. While CUAC believes that banning exit fees would strengthen the market and ultimately deliver consumer benefits, we prefer the reform model that we have proposed and believe this will be of even greater benefit to Victorian consumers.

What does the research say?

CUAC recently conducted research into Victoria's competitive retail energy market. That research highlighted some serious concerns about the level of consumer understanding of the energy market, the quality of information available to them and the level of complexity associated with retail market offers. One of the recommendations of that research was to improve the regulation of fixed term contracts as proposed here. The full recommendation is included below:

> *Fixed term contracts should come with a price that does not change over the course of a contract. Under current arrangements, whereby retailers can raise the prices of market offers periodically during the contract, consumers bear all the risk of their choice. Even if a consumer succeeds in finding the best offer for them at a particular point in time, a price increase can render the time spent in their decision-making worthless. On the other hand, retailers enjoy the certainty of having secured the customer for a particular period of time. A key reason for having a retailer is to mediate the inherent risks and volatility upstream in energy markets into products that mitigate these issues for end users. Allowing contracts within which prices can be increased even though the customer has signed up for a fixed term abrogates retailers' market responsibilities.*