SUPPORTING ENERGY CUSTOMERS IN FINANCIAL HARDSHIP: UNTYING THE GORDIAN KNOT ?

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The Essential Services Commission is Victoria's economic regulator. The Commission regulates the Victorian retail energy sector through monitoring and enforcing compliance with licence conditions and Victoria's energy retail codes. In this Paper, Dr Ben-David provides a 'prologue' to the Commission's current *Inquiry into the Financial Hardship Arrangements of Energy Retailers.* He argues that targeted regulatory intervention is required because customers are "trapped" in the market. Dr Ben-David examines the limited options available to regulators (and energy retailers) to assist customers in financial hardship and discusses the impact on customers, and the overall market, of accumulated debt from unpaid bills.

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* The opinions expressed in this presentation are those of the author alone. They do not represent the views of the Essential Services Commission, its staff or the Victorian Government. The author takes full responsibility for any errors, omissions or conjectures made herein.

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1. INTRODUCTION

What is it about energy?

I don't know about you, but I don't recall ever hearing anyone advocating that petrol stations should offer their customers a payment plan if their customers are struggling to pay for their petrol. And I don't remember ever hearing about a consumer group demanding that a supermarket undertake an assessment of capacity to pay before determining how much a customer is required to pay for the goods being purchased. I don't have any recollection of calls for internet service providers to be banned from charging late payment fees on an overdue bill. And I don't recall ever hearing of any suggestion that car mechanics should be required to advise their customers about how they might reduce their maintenance costs by driving less. I certainly don't remember the last time a regulator was required to report on how well mechanics or petrol stations or supermarkets or internet service providers were supporting their customers in financial hardship.

Yet, aren't petrol and cars and food, essential goods and services? Even internet access is rapidly become a non-discretionary requirement for someone expecting to participate economically and socially in today's technology-based world. When was the last time anyone here tried to apply for a job without accessing the internet?

Despite petrol and cars and food and internet access being essential items for modern life, providers of these services are not bound to offer payment plans to their customers, nor are they required to undertake assessments of their customers' capacity to pay, nor are they banned from charging late payment fees; and they are not obliged by law to help customers reduce their reliance on the goods or services they sell.

Yet in the regulation of energy markets, these are precisely the protections that we see in place for customers who may be experiencing financial hardship. Why?

As I asked a moment ago, "What is it about energy?"

What is it about energy that results in regulatory obligations being imposed on the providers of electricity and gas to ensure they exercise the highest degree of caution and diligence before disconnecting a customer — especially, and just in case, that customer may be experiencing financial hardship?

Although this is an intriguing question, it is not one we have sought to explore — at least not in any detail — in the issues paper we released a few weeks ago to commence our review into the hardship practices of energy retailers operating in Victoria.

The easiest thing for me to do today would be to stand here and just prattle off the details of the issues paper we released on our *Inquiry into the Financial Hardship Arrangements of Energy Retailers*: what our terms of reference require us to do; the processes we will be following and the reports we'll be releasing; as well as our commitment to consulting widely.[1] I could then walk from the podium safe in the knowledge that I had done nothing: nothing to upset anyone; nothing to 'rock the boat'; nothing to enliven a debate — a debate that we really need to pursue if we are genuine in our objective of understanding what we really mean and expect by terms such as "supporting customers in financial hardship".

The reality of inquiries of this type, is that too often and too quickly and too willingly, the parties overlook the big questions and jump straight into the detail: What protection is in place and how should it be tightened or loosened (depending on which side of the debate the parties sit). But this is like arguing

[1] Essential Services Commission 2015, *Inquiry into the Financial Hardship Arrangements of Energy Retailers: Our approach,* March 2015.

about what colour upholstery we want rather than what type of car we need; or indeed, why do we need a car in the first place? Shouldn't our first question be: Where do we want to go? Or the even more fundamental question: Why do we even think we need to go there?

In my experience, inquiries of this type too rapidly descend into debates about upholstery rather than destinations.

So today, I am not going to discuss our inquiry — with apologies to the conference organisers. I have every faith that you will read our issues paper if that is what interests you. Rather, I want to come back to my opening questions of, "What is it about energy?" or more precisely: What is it about energy markets, and the circumstances of customers in those markets, that gives rise to expectations and obligations that we don't see in other markets? (particularly, obligations affecting customers experiencing financial hardship)

For the avoidance of any doubt, the observations I am about to make are correctly characterised as propositions or hypotheses for debate. They are <u>not</u> conclusions. As I've already noted, I want to encourage a discussion — <u>not</u> close it down.

2. **BUT ENERGY IS DIFFERENT...!**

Anyone who works in, or with, the energy sector will tell you that, "Energy is different". Likewise, anyone who works in or with the water sector will tell you that, "Water is different". And the same goes for petrol, and banking, and local government, and taxis, and supermarkets, and childcare, etc, etc, etc.

Of course, they are all different. We must not, however, accede to these claims of difference as an excuse for 'special treatment' of service providers or customers. Conversely, we should not dismiss claims of alleged 'difference' merely as a form of special pleadings by vested interests. Rather, we need to place ourselves in the critical centre, as sceptics (in the true meaning of that term), and judge for ourselves: What is *genuinely* different about the circumstances of any particular market? And if there is a genuine difference, what response is *genuinely* required to address that difference?

So energy is different. But of course it is; we've already established that claim. But, so what? What is it about energy markets — or to be precise, retail energy markets — that means we ought to care enough to intervene in that market in ways that we might not intervene in other markets?

Yes, energy is essential for most people's well-being and economic participation, but is it really any more essential than a whole bunch of other goods and services? Apparently so. What other explanation could there be for the similar regulatory responses observable in jurisdictions all over the world. But what is it that makes energy so truly different that it warrants special regulatory intervention to protect customers and especially those in financial hardship?

To start, it might be worthwhile eliminating some features of this markets that are probably irrelevant. One irrelevance might be the nature of industry's ownership structure, that is, whether it is privately or publicly owned. Retail energy providers (at least in Victoria) are fully in the hands of private sector, while the water industry is publicly owned. Nonetheless, the two sectors contain similar provisions designed to protect customers experiencing financial hardship.

Another irrelevant feature might be the number of providers. Depending on who you want to include, there are at least a dozen active electricity retailers operating in the Victorian market and to whom most customers will have access. At the same time, we only have one provider of metropolitan train services; and most of us are completely beholden to one local council with little scope for genuine recourse if we are dissatisfied or aggrieved. Yet despite the providers of these other services enjoying effective monopoly status, they are not subject to the types of customer protections we see in the energy retail market.

So if the structural features of the industry cannot answer the question about why energy is different, then the answer must lie elsewhere. I propose that the essentiality of retail energy markets can be found in two places: first, the nature of the *product* being sold; and second, the nature of the *transaction* between customers and retailers. Let me turn first to a discussion of the nature of the product.

2.1 The product

It may be true that one can probably survive in a corporeal sense without purchasing electricity (or gas), but this is a silly and trivial observation. Clearly, the absence of refrigeration while not necessarily life-threatening would be highly disadvantageous for any number of reasons — such as: exposing people to health risks and requiring them to devote more of their waking hours to accessing fresh food. Both have a clear economic consequence in terms of the person's ability to uphold any form of employment. This in turn may have social consequences if the person becomes disengaged from society. Further, there may be fiscal consequences if that person becomes a long-term dependant of welfare.

Even in a less physical sense, where would we be without electricity to charge our computers, tablets and smart phones? Yes, we could probably manage without these devices, but our ability to navigate our way through modern life would be compromised severely.

Yes, electricity is genuinely essential; but I want to be very clear about the nature of this argument.

My argument about the essentiality of electricity is not based on a view about morality or fairness or what is right. It is not about social justice or entitlement. Moral arguments are not very helpful. They are too complex because they must always be considered relative to other moral imperatives.

(I can tell you from my own observations of political decision-making over many years, politicians are at their most awkward when they are required to prioritise between competing moral imperatives. What is more important from a moral perspective: establishing a women's refuge, protecting the environment or investing in the courts' capacity to uphold property rights? Do not try to answer that question. It is offered only for rhetorical effect. Imperatives that rely on competing claims to morality are fraught with decision-making potholes from which there is rarely any satisfactory relief.)

My arguments about the essentiality of energy are predicated on economic notions — such as the consequent misallocation of labour resources if people are unable to participate in employment markets. Likewise, diversion of society's resources into providing health services (because of people becoming sicker), is probably less efficient than avoiding the need for those services in the first place.

You might be critical that I am describing human suffering in terms of a resource misallocation problem. I guess you can now see why economics is known as the 'dismal science'. Dismal it may be, but very useful nonetheless. Economics provides an extremely powerful analytic device because it helps us to show that by underproviding energy, retailers can impose costs on society-at-large. Retailers impose costs on society when they withhold supply from customers who might otherwise be willing to pay, but who may not immediately be capable of doing so.

We, the practitioners of the dismal science, know this as an 'externality problem'. In other words, while an energy retailer will take into account the costs and benefits it incurs from disconnecting a customer, it will not take into account the costs that accrue elsewhere in society. Or to put this in another way still: you and I may benefit if a customer is kept supplied with electricity so that they can refrigerate their food and avoid ending-up sick in the hospital system for which we must pay through the taxation system. However, whether someone eats spoiled food is not the concern of an energy retailer whose expertise is in intermediating between wholesale markets and end-users of electricity; operating a billing system; and earning a reasonable rate-of-return while doing so.

As a result, if left to their own devices, energy retailers will disconnect customers more readily than society might otherwise prefer. Again, this is not a moral argument. It is not about what is fair or just. It is about the best use of society's resources; or alternatively, avoiding the misuse of society's resources.

Even though society can benefit from fewer people being disconnected, avoiding these disconnections will come at a cost. It must come at a cost because if left to their own devices, retailers would disconnect customers who represented an ongoing risk of bad payment history. The point in time **—** *and debt* **—** at which the customer is disconnected will depend on the individual retailers' tolerance to the probability that payment will never be received. It is appropriate to assume that commercial entities will, in general, and definitely over the medium term, tend to risk aversion **—** meaning, for example, they might prefer to disconnect a customer even if there is a fifty per cent chance that the customer will eventually be able to settle amounts in arrears.

The retailer discontinues supply because it is unwilling to accept the risk of past and future unpaid bills. Individual retailers will vary to some extent in their tolerance to such risks but that is for them to determine. Such matters of preference can never be determined by regulatory fiat.

If from a society-wide perspective we want retailers to avoid disconnecting customers at a lower rate than they otherwise might — in other words, if we want the retailer to accept more risk of bad debts — then we also need to resolve the question about who is responsible for compensating the retailer for assuming that unwanted risk? (This issue is beyond the scope of this paper.)

The important point, for now, is this: We can expect, all things being equal, that the commercial interests of an energy retailer and the economic interests of society will not align. Alternatively stated, from a society-wide perspective, we can expect that retailers may disconnect customers more readily than society would think is appropriate.

I have spent the last few moments establishing an argument for why society might demand that governments intervene in the avoidance of disconnections that retailers would otherwise be inclined to pursue.

But there is another argument that deserves airing.

2.2 The transaction

Recall, a few moments ago I stated that the essentiality of energy can be found in two places — in the nature of the product and in the nature of the transaction. I will now provide some brief comments on the transactional context in which retailers and customers engage with each other.

Households can discontinue, or at least delay, the purchases of many every-day goods and services when facing domestic budget constraints. Energy purchases cannot readily be delayed or discontinued. And, to the extent we do have some capacity to lower our usage, this often requires an upfront outlay (for example, in new appliances or insulation). It costs money to save money.

These constraints on setting aside energy purchases, markedly redefines the nature of the transaction involving customers and their energy retailers. Unlike almost every other market, electricity customers are "trapped" in the market. Sure, they can switch between retailers if they are dissatisfied, but customers cannot exercise the most powerful sanction of all — and that is, they cannot 'walk away' from the market.

To explain this by analogy…

Coke and Pepsi have been the most vigorous of retail competitors for over a century. Their advertising budgets are vast — yet what is the biggest threat to, say, Coke? It is not that some of its customers will switch to drinking Pepsi. That is a problem, but those customers can be won back with a bit of extra effort. No, the biggest existential threat to Coke is that some of its customers will stop consuming cola drinks altogether; maybe switching to coconut water or flavoured milk.

That option, of being able to walk away from the market, is not an option that electricity customers share. Electricity customers cannot exercise this ultimate sanction. They can switch from one retailer to another, but if none satisfies their requirements, they cannot just walk away from the market. Consumers are "trapped" — stuck in the market whether they are satisfied or not with what that market is offering.

And here is the important point. Not only are consumers trapped in the market, but the energy retailer <u>also</u> knows that those consumers are trapped. Or to be more precise, energy retailers collectively know their customers are trapped; that that they cannot leave the market no matter how dissatisfied they may be. Now that knowledge about customers *must* alter the way retailers operate, individually and collectively; and it must do so in a way that is to their advantage.

(I will be providing a paper at a conference next month in which I will explore this issue in more detail.)

This disparity in market power between retailers and consumers is a potential source of "market failure" whereby society is worse-off than it otherwise might have been had consumers and retailers been transacting on a more level playing field.[2] While the playing field may be uneven for all consumers, it is surely most uneven for those consumers who are most unable to engage with that market (for example, customers whose purchasing power is compromised because they are experiencing financial hardship).

3. MORALITY DOESN'T HELP

As in the earlier discussion, this argument about disadvantage in market transactions has not relied on moral exhortations about what is right or wrong, fair or just. Why is this so important? Because as an economic regulator it is not my role to judge what is right or good or just.

This means that if you plan on making a submission to our inquiry, you are clearly at liberty to write or demand anything you wish. Let me suggest, however, that to have the most influence on our thinking, you should not base your claims on arguments about what is right and what is wrong. After all, who can say that your views about what is right are indeed right — and who can say they are wrong? Certainly, not me. It is not for me to sit in judgement of you and your views about what is fair or just. It is not up to me to determine whether your view about what is right, is indeed the right view.

This description of our role may be jarring to some of you — but if your submissions to our review are to be most effective, then I urge you not to rely on assertions about what is right or what is fair. Rather, I urge you to build your arguments on objective propositions, verifiable evidence and sound reason.

[2] Market failure is a situation in which the allocation of goods and services is not efficient. That is, there exists another conceivable outcome where an individual may be made better-off without making someone else worse-off. (The outcome is not Pareto optimal.)

Our role is to determine what will work best when seeking to assist customers in financial hardship avoid disconnection while at the same time, upholding the stability and sustainability of the overall market. And how will we do that?

We have explained our approach in the short issues paper we released a few weeks ago. In that paper, we laid out the principles — or the 'filters' — that we will apply as we assess proposals for improving the way the regulatory regime supports customers experiencing difficulties in paying their bills. These principles are standard tests of best practice regulation and include: effectiveness, flexibility, consistency, efficiency and proportionality, transparency and clarity, and accountability.[3]

4. THE REAL PROBLEM ?

So far, I have established that there are important reasons *why* governments intervene to restrict the ease with which energy retailers are permitted to disconnect their customers from supply. I have also discussed *how*, as the regulator responsible for establishing and administering the regulatory framework, we will go about looking to fix or improve the framework during our inquiry.

I will now turn to the 'what question'. *What* are we trying to fix or improve as we conduct our inquiry? What is the underlying problem?

As already argued, there are powerful reasons why governments might impose controls on how and when energy retailers can disconnect a customer. To answer the 'what question', we need to look at the consequences of those controls. One typical chain of events will unfold as follows.

[3] Essential Services Commission 2015, *Inquiry into the Financial Hardship Arrangements of Energy Retailers: Our approach,* March 2015. See chapter 2.

A retailer observes that a customer has failed to pay a bill or possibly successive bills. At this point, the regulatory framework takes effect and compels the retailer to engage with the customer. In short, these obligations require various forms of communication to ascertain the reason for non-payment — primarily, whether the reason for non-payment is related to financial hardship. These requirements are followed by obligations requiring the retailer to offer different mechanisms to assist the customer to pay the amount outstanding — thus avoiding disconnection. If these arrangements prove to be insufficient, the retailer is obliged to pursue further efforts to assist the customer. If despite these repeated attempts, the retailer still does not receive payment, the regulatory framework outlines the steps and timelines the retailer must follow before disconnecting the customer.

Bear in mind that throughout this entire process — and it can takes weeks and even months to unfold — the customer is continuing to draw supply. To be clear, this is a deliberate outcome: namely, to exhaust all options before the final, and most draconian step of withdrawing supply is effected. (Alternatively this can be expressed in the language of the Terms of Reference for our inquiry as: ensuring that customers are only disconnected as a last resort.) All being well, disconnection is avoided altogether if the retailer and customer can reach a satisfactory settlement. But even if disconnection proceeds, it may not be the end of the story. Following disconnection, customers will often turn to the Energy and Water Ombudsman of Victoria (EWOV) in desperation. EWOV will usually arrange for the customer to be reconnected (often very quickly) while it conducts its assessment of whether the retailer has complied with the Energy Retail Code.

Throughout this process, and bear in mind it can takes months to play itself out, the customer has been maintained on largely uninterrupted supply. This is clearly the intended effect of the framework — but there are consequences. For as long as customers continue to draw supply, and not pay in full for that supply, their indebtedness to the energy retailer continues to climb: and from the retailer's perspective, it continues to accumulate debts of questionable quality.

This story can be contrasted with the management of customer debt elsewhere in the economy.

Elsewhere, a service provider will — or at least has the option to — cauterise a customer account that is haemorrhaging debt. The business will prevent itself — and indeed, its customers (!) — from 'bleeding out' on debt. In a competitive market, businesses must take this action because they cannot simply raise their prices to cover the costs of their bleeding wounds. If they fail to stem the haemorrhage, they will eventually see their profits bled away. As profits seep away, the quality of their service declines as fewer funds are available to maintain and invest in the business. Customers 'vote with their feet' and the business enters its death spiral.

But like I said a while ago, "energy is different". Customers cannot 'vote with their feet'. They are trapped in the market and retailers know this; so how will those retailers respond?

To make things a bit easier, let us assume that all (or most) retailers are managed with more-or-less equal competence. We can then also assume that all retailers will be carrying a more-or-less proportionate share of those customers who may be experiencing trouble paying their bills. This has at least two consequences worth noting.

First, no individual retailer is placed in a competitive disadvantage from which it has a compelling incentive to extricate itself. The main incentive operating in the market would be for each retailer to ensure it is *no worse-off* than its competitors.[4] The second consequence of accumulating debt is that, unlike in a

[4] It might be suggested that competition should spur competing retailers to better manage their customer debt. Better debt management would free up capital allowing the retailer to offer better services or under-cut its competitors. Based on his observations, the author contends that this potential source of competitive advantage appears to be insufficiently strong to warrant the required effort by a retailer. That is, observation

'normal' market in which individual providers can cauterise their debt or become destabilised and go bust, in the energy retail market the debt becomes a drag on the whole market rather than just individual retailers. In response, prices may go up — after all, customers cannot escape those higher prices — but there are *some* constraints on price rises. Over the longer term, demand curves, even in the energy sector, have a habit of sloping downwards. Firms would initially absorb some of the losses due to accumulating debt, but they would not do so for long. They would soon look to start cutting costs elsewhere: in areas such as service standards and product innovation. And of course, customers cannot leave the market. They have no option but to 'cop' the consequences of a retail energy market that lacks a focus on customers and their needs. Customer dissatisfaction grows; media interest is piqued; and policy makers start to pay attention.

And so we have, what may be called, the "essential service conundrum".

Retailers and customers become locked in a non-commercial embrace. Neither party can let go of the other: customers are bound to the market due to the essentiality of the service; and commercial retailers are bound to customers because of the law responding to the essentiality of the services they provide (that is, the financial hardship framework). In time, retailers' *modus operandi* shifts from seeking to create customer value (as they would in a normally competitive market), to the far lesser ambition of ensuring they are simply 'no worse' than their competitors.

How is an economic regulator expected to respond to such circumstances — especially when its governing statutes require it to "promote the long term interests of (Victorian) consumers" and to "promote the development of full retail competition".[5] How is the industry regulator expected to respond to such

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suggests that, at least historically, retailers have had a weak incentive to outperform their competitors in managing customer debt. Conversely, it seems a strong incentive operates to avoid underperforming relative to the overall market.

[5] See s.8 of the *Essential Services Commission Act* 2001 (Vic), s.10 the *Electricity Industry Act* 2000 (Vic) and s.18 the *Gas Industry Act* 2001 (Vic), respectively.

circumstances when asked to conduct an inquiry into the financial hardship arrangements of energy retailers?

5. A LIMITED NUMBER OF INPUTS AND OPTIONS

So far, this story of essentiality of service, debt accumulation, declining ambition and mounting discontent, is a story told at the aggregate level. It is a story about the market 'as a whole'. But markets are abstract constructs created by economists and lawmakers. In reality, markets are composed of individual customers, individual providers and individual transactions — and some proportion of those customers will be experiencing financial hardship.

5.1 Inputs

When all is said and done, a limited number of variables will determine whether an individual customer can pay his or her account in full and on time. These variables are described by the following notional equation.

$$\text{“ability to pay”} = \int f\{ Y - C_{oL} - (P * Q) - r(D) \, ; X \} \, dX$$

Where: Y = income

C_{oL} = cost of living expenses

P = price of electricity (or gas)

Q = amount of electricity (or gas) consumed

$r(D)$ = repayment of account arrears (D = debt)

X = vector of interactions between a consumer and a retailer

This pseudo-mathematical equation is simpler than it looks.

First, it suggests that an energy bill is more payable the more income someone earns. No rocket science on that score.

Second, an energy bill will be *less* payable if the customer is confronted with many other cost of living expenses. Likewise, the bill will be *less* payable if energy prices are high or if the customer is consuming a lot of energy.

Third, the equation indicates that if a customer's account is already in arrears, it will be harder to pay each successive bill.

The ability of a regulator — and indeed, an energy retailer — to support customers in financial hardship, can also be examined through these variables.

5.2 Options

Starting with income (Y): Clearly, this is a variable over which neither regulator nor retailer has much influence. At best, retailers can — or can be required to — assess whether a customer is eligible for, and receiving, the relevant income support measures offered by federal and state governments. At a state level, or at least in Victoria, concessions are the main income support mechanism available.[6] The design of this program is beyond the control of the regulator and outside the scope of our current inquiry. It is worth noting, however, that St Vincent de Paul examined concession policies around the country and assessed Victoria's as favourable.[7]

By cost of living expenses (C_{oL}), I am referring to all those other expenses households incur in order to function. I do so non-judgementally, meaning: I

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[6] Utility Relief Grants (URGs) are also available. These grants are provided on a one-off and limited basis to assist customers experiencing financial hardship.

[7] St Vincent de Paul Society and Alviss Consulting Pty Ltd 2013, *The relative value of energy concessions 2009-2012. Part 2 of the Vinnies' Concessions Project.* Melbourne. 21 March 2013

assume that each household determines the purchases it requires and it is not up to me, as the regulator, or an energy retailer, to be advising households otherwise. In other words, this is a variable outside the control or influence of the regulator and retailers.

The next variable is more interesting, namely, the price (P) of electricity or gas. First, we must acknowledge and accept that prices are fully deregulated in Victoria. Nonetheless, there are other ways in which regulators and retailers may influence the prices paid by customers. Our Energy Retail Code already requires retailers to ensure that customers in a financial hardship program are on an “appropriate” tariff.[8] Looking to the future, the emergence of more complex tariff structures makes this expectation look somewhat fraught. With the advent of smart meters in every home and flexible tariffs, the “appropriate” tariff choice will become increasingly dependent on the energy usage profile. These usage profiles, in turn, depend on household dynamic; and household dynamic is itself a dynamic variable. Usage profiles could change markedly if, for example, a member of a household starts or loses a job, or goes on to a night shift; or if a child leaves (or indeed, returns) home; or if household appliances breakdown; etc. So a flexible tariff that may have looked good when an assessment was undertaken in one circumstance, may be quite contrary to the customer’s eventual interests.

The next variable refers to the quantity (Q) of energy consumed by the household. Experience suggests that regulators, retailers and policy makers can have some influence on this variable. State energy efficiency programs such as the Victorian Energy Saver Initiative[9] and the federal government’s former Home Energy Saver Scheme (HESS) are cited by consumer and welfare groups as having provided some benefit to customers in hardship by helping them lower their energy consumption and their bills. It is also worth noting retailers

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[8] Clause 71B(2) of the Energy Retail Code (Vic) states: “ …the Commission expects a retailer’s customer hardship policy to... require the retailer to monitor [the customer’s] behaviour and consumption during their participation in the customer hardship program to ensure that they continue on the most appropriate tariff and facilitate a change if necessary.”

[9] Also known as the Victorian Energy Efficiency Target, which is administered by the Essential Services Commission and established by the *Victorian Energy Efficiency Target Act* 2007.

already offer support to their customers with information about how they might better manage their energy bills — albeit to differing degrees. As far as the regulatory framework is concerned, the question is: which types of obligations should be imposed on retailers to provide this type of assistance? Clearly, retailers will generally benefit from selling more energy, not less — but selling less energy and getting paid for it, is presumably a better outcome than selling more energy and not getting paid for it. Likewise, from a customer's point of view, using less energy and avoiding the risk of disconnection must be better than using more energy and incurring that risk. All things being equal, it would appear that the interests of retailers and customers are generally aligned. Which begs me to ask: Why, then, should regulators even consider intervening in such matters?

The next variable is particularly interesting as it refers to account arrears or the debt owed by a customer to the retailer, r(D). No matter how those arrears arose, the higher they are, the more difficult it will be for households to get their heads 'back above water'. The Victorian Code provides some protection insofar as it places a limit on arrears that can be recouped if those arrears were caused by the retailer failing to issue bills to a customer. This protection is clearly very specific and will not be relevant in other instances. I have heard from financial counsellors of household accounts that have fallen into arrears by many thousands of dollars. This raises some very important questions. Who is really responsible for account arrears reaching such disproportionate levels? Should the customer have contacted the retailer and advised that he or she was struggling to pay their bills? Should the retailer have acted earlier when bills were repeatedly not paid, or not paid in full? Who is responsible for the arrears reached and therefore who should ultimately bear the consequences of that debt? The answers to those questions are far from straightforward.

So there are a limited number of variables that contribute to how readily a customer will be able to pay their energy bills: income, cost of living expenses, the price of energy, the quantity consumed and account arrears. The regulatory frameworks cannot deal with — or at least not readily so — many of these factors. So what is left?

5.3 The X-factor

I believe it is the ‘X’ factor in my notional equation which I have described as “the vector of interactions between a consumer and a retailer”.   In plain English this refers to the multitude of ways in which retailers and their customers engage with each other. This includes the way they exchange information, whether it be by: phone, mail, email, websites, text message, Instagram; or television, radio and newspapers. It is worth noting that information exchange would also include how smart meters and load control devices are used. The ‘X’ factor would also include the way customers and retailers exchange funds, namely, payment methods — but also payment arrangements.[10]

The ‘x’ factor refers to any exchange (or *attempted* exchange) in whichever direction — from retailer to customer, or from customer to retailer. I expect that it is an assertion beyond dispute that when this transactional context works well, customers in financial hardship sustain better outcomes. Where I expect the parties to be more prone to dispute, however, would be in their expectations of what should be required and what can be achieved through regulatory intervention via the Energy Retail Code.

One notable example is: Empathy. Report after report from consumer organisations have criticised call centre staff’s lack of awareness — or the lack of willingness to even try to be aware — of a customer’s circumstances and therefore the difficulties the customer may be facing in paying outstanding

[10] ‘Payment method’ refers to the vehicle by which a payment is offered and accepted (eg. credit cards, cheque, electron funds transfers). ‘Payment arrangement’ refers to any agreement on how customer payments are distributed over time (sometimes called: payment plans or instalment plans).

energy bills.[11] If true, that is a reasonable criticism. It is less clear how a regulator might respond to such concerns.

Another more contentious example pertains to the notion of 'capacity to pay'. The retail code contains obligations on retailers to consider or assess a customer's capacity to pay when putting the customer on a payment plan. Over the years, consumer and welfare groups and the Energy and Water Ombudsman (EWOV) has sought clarification from the Commission about the factors that must be taken into account when a retailer conducts such an assessment. We have resisted these calls for three reasons. First, no matter how extensive a list of relevant factors we were to compile, it would never be exhaustive and so there would always be customers who 'fall through the cracks'. Second, as a regulator we are required to take into account the cost as well as the benefits of any regulatory obligation we create. Clearly, if we establish a long list of factors that retailers must assess, this will impose considerable compliance costs. Eventually, those costs will be passed through as higher prices or lower service standards. Third, is it really the role of the industry regulator to alter the fundamental characteristic of the industry it regulates? Or, to put it more provocatively: How and why should the regulator be expected to turn an energy retail company into a financial counsellor? Energy retailers intermediate between wholesale markets and end-use customers. *That* is their area of expertise. If they do it well, they prosper. If they stuff-it-up, they fail. But, surely no-one contends that, with the stoke of a regulatory pen, a financial intermediary and a financial counsellor can be deemed to be the same thing.

So we are left with an obligation for retailers to consider 'capacity to pay' or suffer the consequences — including financial penalties under Victoria's wrongful disconnection framework — but we have no idea about the efficacy of that obligation. Is it time we moved on and fundamentally reconsidered the regulatory obligation to assess 'capacity to pay'?

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[11] For example: Financial and Consumer Rights Council (2014), *Rank the Energy Retailer. Victorian financial counsellors rank the financial hardship policies and practices of energy retailers*, August.

6. CONCLUSION

Retail energy markets (particularly: electricity) belong to a very small and very unique class of markets from which customers cannot escape. The demands of modern life deny customers the opportunity to exit the market voluntarily — to 'walk away' because of dissatisfaction or because of their limited resources and competing priorities. This immediately places energy retailers in a position of advantage in their relationship with their customers, which necessitates the regulatory intervention that we see in retail energy markets the world over.

The consequences of this unevenness in the retailer-customer relationship are most immediate when customers have failed to pay their bills. Acting rationally and in their own commercial interests, retailers will seek to discontinue that relationship by disconnecting the customer from supply. But these disconnections can be highly undesirable — not because they are wrong or unfair or unjust, but because they can produce undesirable economic outcomes for society. As a result, governments have intervened to limit energy retailers' discretion to disconnect their customers experiencing financial hardship. But this causes debt to accumulate in the market at an uneconomic rate. This debt acts as a break on investment in service delivery and market innovation (and it may drive up prices).

For these reasons, dealing with financial hardship is perhaps the most vexing of problems we face as a regulator charged with promoting the long term interests of *all* consumers.

This is a Gordian knot in manifold dimensions: A knot of issues and consequences; rights and obligations; choices and capacities; customers and retailers. This knot sits in a rope with no free ends; no obvious starting point from which we might begin to unravel its entangled mesh of concerns.

I encourage you — indeed, I urge you — to engage with us as we seek to solve the mystery of the knot; as we undertake our *Inquiry into the Financial Hardship Arrangements of Energy Retailers*.

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