21 January 2022

Dear Professors Raven, Pink and Adey

Thank you for inviting me to make a submission to the *Just Transitions in Australia: Moving Towards Low Carbon Lives Across Policy, Industry and Practice* project. I welcome and congratulate your work in this area. In my experience, it is a greatly overlooked component of the *domestic* transition endeavour. (Noting, the COP and other international forums provide an opportunity for the airing of concerns about justice in an international sense.)

**Introduction**

My thinking about these issues is largely grounded in debates about the transition of the domestic energy (electricity and gas) market and the appropriate regulatory response. While the energy transition is only one part of the much larger societal and economic transitions that lie ahead, in some ways, it provides a useful microcosm (or metaphor?) of the broader challenges. While the following comments reflect my experiences in contemplating just outcomes in the energy transition, I trust these observations may have broader relevance.

In this submission I address two concerns arising from the energy transition. The first operates at a human scale insofar as it refers to the experiences consumers can expect to face during the transition of the energy market. The second concern operates on a non-human scale although it has a large bearing on consumer prices. It addresses the recovery of sunk investments and stranded assets.

I appreciate these two concerns may seem somewhat oblique to the overall transition challenge. Likewise, they may seem rather technical and specific to energy markets. But that does not make them any less relevant. At their heart, these two discussions seek to highlight that transferring risks and costs to consumers, and relying on markets to dissipate any adverse consequences from doing so, may be placing an unrealistic expectation and burden on consumers. If consumers reach the same conclusion, they are likely to lose confidence in transition-oriented policies – thereby putting at risk the success of those policies.
The submission’s conclusion briefly reflects on my experience in public policy and how decision makers can become overly focussed on the elegance of systemic solutions rather than people’s ordinary experience of those solutions.

What is a just transition?

Of course, the prior question that must be answered clearly before pursuing a just transition is: What does such a transition look like? Any room full of people will come up with a room full of different definitions or criteria. The British Academy website (link provided in your letter) refers to principles such as: the involvement of all relevant actors, widely sharing the benefits of decarbonisation, supporting those who stand to lose, building capacities and capabilities – while clearly recognising diversity among communities and sectors.

In areas of the economy where the transition is expected to be mediated through market mechanisms – such as in the energy sector – it seems policy makers and regulators are assuming that a just transition will be achieved when:

- prices reflect cost so there is no cross-subsidisation between services, customer cohorts, regions, technologies, and so forth
- customer choice is wide-ranging therefore supporting the opportunity for the efficient matching of consumer preferences with the varying offerings of service providers
- consumers are empowered through better information disclosure and other mechanisms that lower transaction costs (particularly market participation and search costs), and
- consumer protections are put in place to prevent and remedy disputes between customers and their service providers.

The first two conditions are pursued through market design whereas the latter two are implemented through regulation. And while both market designers and regulators often claim to attend to affordability, they typically do so in the abstract only. For the main part, they view the denial of access to services caused by insufficient income as a matter for government social policy (eg. via concessions or welfare payments).

If, for the moment, we are prepared to set aside this last point (about affordable access to services), it is still worth asking whether the four dot points are sufficient for ensuring just outcomes for consumers.

In large part, the answer will depend on whether consumers voluntarily participate in a market. Where customers retain the option of exiting the market if they are dissatisfied (whether due to reasons of price, quality or trust), the four conditions listed above are probably sufficient for the most part. Where services are involuntarily purchased (because those services are “essential”), it is not self-evident that satisfying the four conditions above are sufficient to ensure community confidence in the fairness of outcomes.
The above four conditions silently anticipate consumers will be interested, capable and willing to respond rationally to price signals, choice and information – and that they will do so continuously and respond vigorously to any changes in prices, choices and information. In voluntary markets, if customers are not prepared to respond vigorously (for whatever reason), they retain the choice of exiting the market (ie. not making a purchase) to avoid being dissatisfied. The risk of this lost custom lies with the supply side of the market.

In contrast, customers in markets for essential services who are not willing or able to respond vigorously cannot exit the market to avoid exploitation. This means there is no risk of lost custom (for the supply side of the market) and the risk of dissatisfaction is transferred entirely to consumers.

The retail end of the energy market is about to undergo a profound reformation where navigating an exploding array of prices, choices and information will become a vastly more complicated (and risky) venture for consumers.

The regulatory community has not contended directly with this inevitability, preferring to place its trust in “the market” to resolve these complexities and risks – that is, the regulatory community continues to pursue the four conditions noted above in the belief the “invisible hand” will take care of the rest.

This is a bold assumption. History has clearly demonstrated that energy consumers are not the rational, calculating, ever-discerning shoppers they are required to be in order for the market to work as per its designers’ intentions. In the future, as in the past, we know consumers will make “wrong” decisions (including “choosing not to choose” – ie. shop around). And even though bureaucrats and theoreticians might argue that such outcomes reflect those consumers’ informed choices, this does nothing to lessen the dissatisfaction those consumers feel.

This approach places at risk the community’s ongoing support for the energy transition. It does so because it fails to recognise that designing consumer energy markets is as much an exercise in political economy as an exercise in textbook micro-economics (or behavioural economics). This political economy derives from the essential nature of energy and the resultant community expectation that however the transition unfolds, consumers will be treated fairly and justly.

Unfortunately, the most appropriate responses to these concerns are not self-evident. All that is clear is that if left unattended, they place at risk a successful energy transition.

The recovery of sunk investments

Many of the sectors which will be central to meeting the challenges of a successful transition are capital intensive – none more so than the energy sector. The transition has two related consequences. First, a great deal of new capital must be raised to fund the investments required to efficiently navigate and successfully deliver the transition. Second, a great deal of existing
assets will (or must) become stranded – meaning their useful lives become shorter than their physical lives.

It is also important to remember that many of these investments, once made, become sunk costs. Every micro-economics student is taught that sunk costs should not influence forward-looking decisions. While economics may have become the lingua franca of public policy, accounting realities continue to reign supreme in boardrooms (and household loungerooms). Sunk assets still influence forward-looking decisions.

In price regulated sectors (such as energy networks), the regulator becomes responsible for the recovery of sunk costs. This poses two problems for regulators.

First, how should the recovery of sunk costs be reflected in consumer tariffs? There is plenty of theory promoting efficient investment in, and efficient use of, regulated assets by setting tariffs at the marginal cost of delivering the service. However, because marginal cost is often considerably below average cost in these capital intensive sectors, these tariffs do not generate enough revenue to cover the total cost of providing the infrastructure services. Unfortunately, there is no theoretical foundation for how this “residual revenue” ought to be collected. This unenviable dilemma has largely been left to regulators to deal with – even though it can have profound consequences for the equitable treatment of users of the services. For example, typically these residual revenues are recovered via a fixed charge per user (i.e. irrespective of their use of the service). This approach may satisfy an efficiency objective, but it is clearly regressive. Elsewhere, I have referred to this outcome as the “original sin of price regulation”.

Second, there are no clear guidelines (policy or regulatory) about how – or even whether – consumers ought to keep paying for regulated assets as they become stranded because of a transition to a decarbonised economy. Clearly, investors invested their funds in the expectation that they would recover their investments over the expected asset lives. It is hardly surprising that if the assets’ useful lives are foreshortened by a transition to a decarbonised economy, then those investors will expect their investments to be repaid more quickly. If regulators accede to these expectations, then consumer prices must rise – potentially making them even more regressive.

Over the next decade-or-two, both of these problems will become more pronounced as billions of dollars of new investment are made; and billions of dollars of sunk assets become increasingly stranded. And in some cases, new investments will need to be made even though they will inevitably become stranded long before the end of their physical lives.

Recovering the costs of all this new investment (plus the cost of stranded earlier investments) will become an increasingly apparent and significant problem over the next decade. How those costs are recovered will have profound consequences for the equitable (and just) sharing of those costs – and therefore, the community’s ongoing support for the transition.

Put simply: While the transition is clearly an existential priority, urgent consideration must be given to how the costs of that transition are to be shared across the community.
Conclusion: The lure of elegance

Many aspects of the transition to a decarbonised economy will occur with little government prompting simply because changing consumer preferences, ecological realities or new technologies will dictate the need for change. But many other elements of the transition will need government policy and regulation either to drive them forward, or to manage their consequences.

In my experience, governments have a tendency to develop solutions to big problems by focusing on fixing “the system”. Too often, too little regard is paid to how people will experience those solutions as they unfold. This is ironic given a government’s longevity is dependent on the confidence of the people – and people tend to judge policies according to how they experience them. Too many policy solutions run into stormy [political] waters only after they have been implemented – that is, when the community finally sees the impact those solutions will have on them.

It is not clear why this occurs but I conject that, at least in part, it is due to the role of bureaucrats and technocrats in developing policies for governments. Head office experts and public servants (of which I was once one) are rarely exposed to the community and almost never need to account to the community for the advice they provide governments. This affords them the luxury of thinking about the impact of policy solutions in only the most abstract terms.

I urge the Just Transitions project to avoid the pitfall of becoming overly focussed on the elegance of a solution (to whichever of the transition challenges that lie ahead) rather than the way those solutions will be experienced by members of the community.

Thank you again for providing me the opportunity to make this submission. I hope it is of assistance. I am, of course, available to discuss these matters further.

I wish you success in your work on this important project.

Yours sincerely

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