
Price Differences and Retail Energy Competition

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Price differences and retail competition

✦ “Encouraging more consumers to participate actively in the market and improving the quality of switching decisions should intensify competitive rivalry among suppliers.

✦ We would expect unfair price differentials to be eroded as a result.”

(Ofgem Energy Supply Probe 2008)

Competition reduces price differentials, but how does reducing price differentials affect competition? And are they unfair?

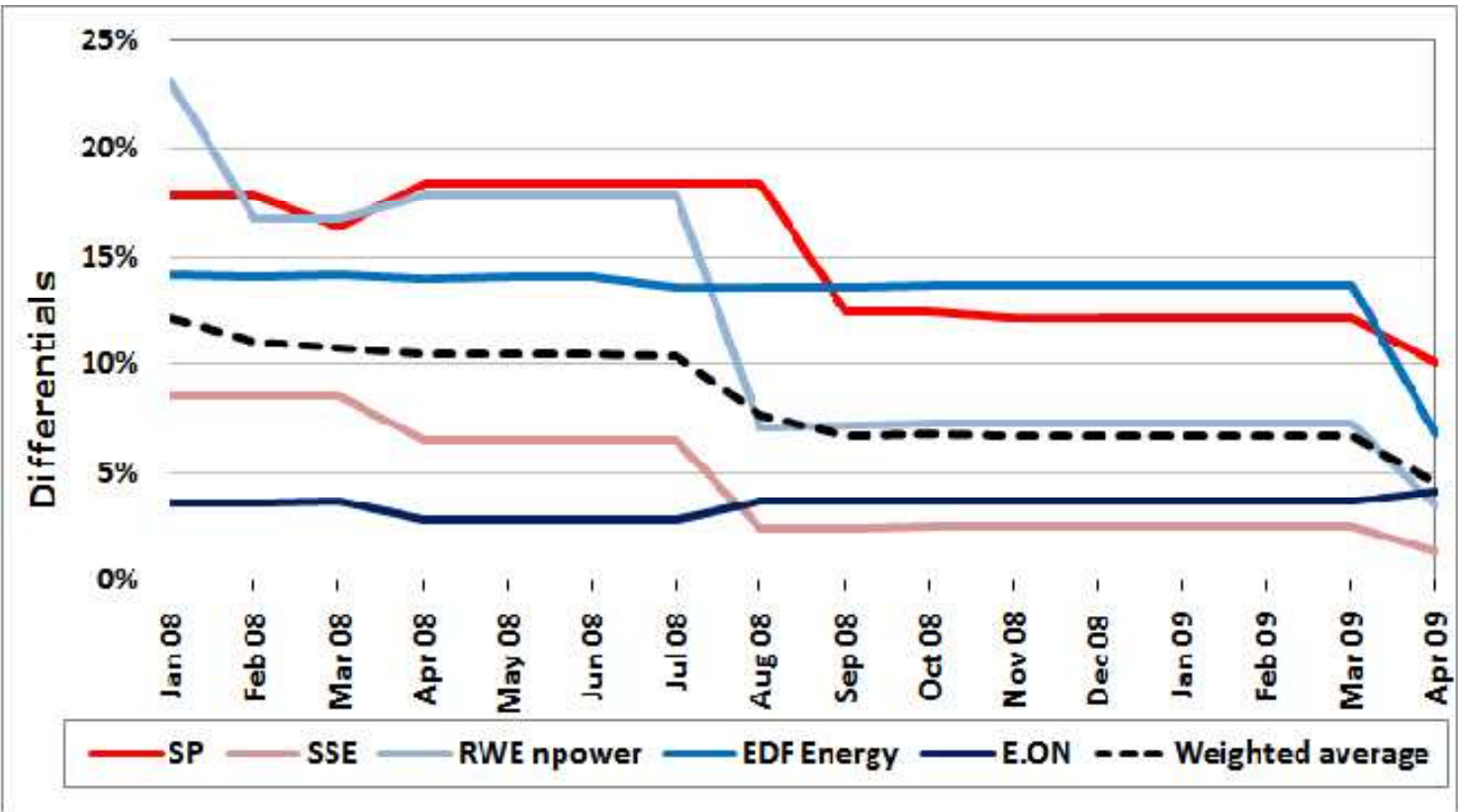
Price differences and retail competition

- ✦ Entry and regional price differences
- ✦ Switching and effect on vulnerable consumers
- ✦ Imposing equal prices:
 - ✦ Short term gainers (and losers) in a zero sum game
 - ✦ Market responses
- ✦ Price differences and fairness in competitive markets: short and long term

Entry & Regional Price Differences

- ✦ British energy market started with 14 regional electricity incumbents and one national gas incumbent
- ✦ At market(s) opening, all entered each others' markets
- ✦ Needed to offer lower prices than incumbent to tempt consumers to switch (overcome switching costs)
- ✦ until July 2008:
 - ✦ Entrants' prices around 10% less than incumbents in each electricity region, average of 7% for gas
 - ✦ These entrants are incumbents in other regions
 - ✦ Incumbents retain around half of consumers

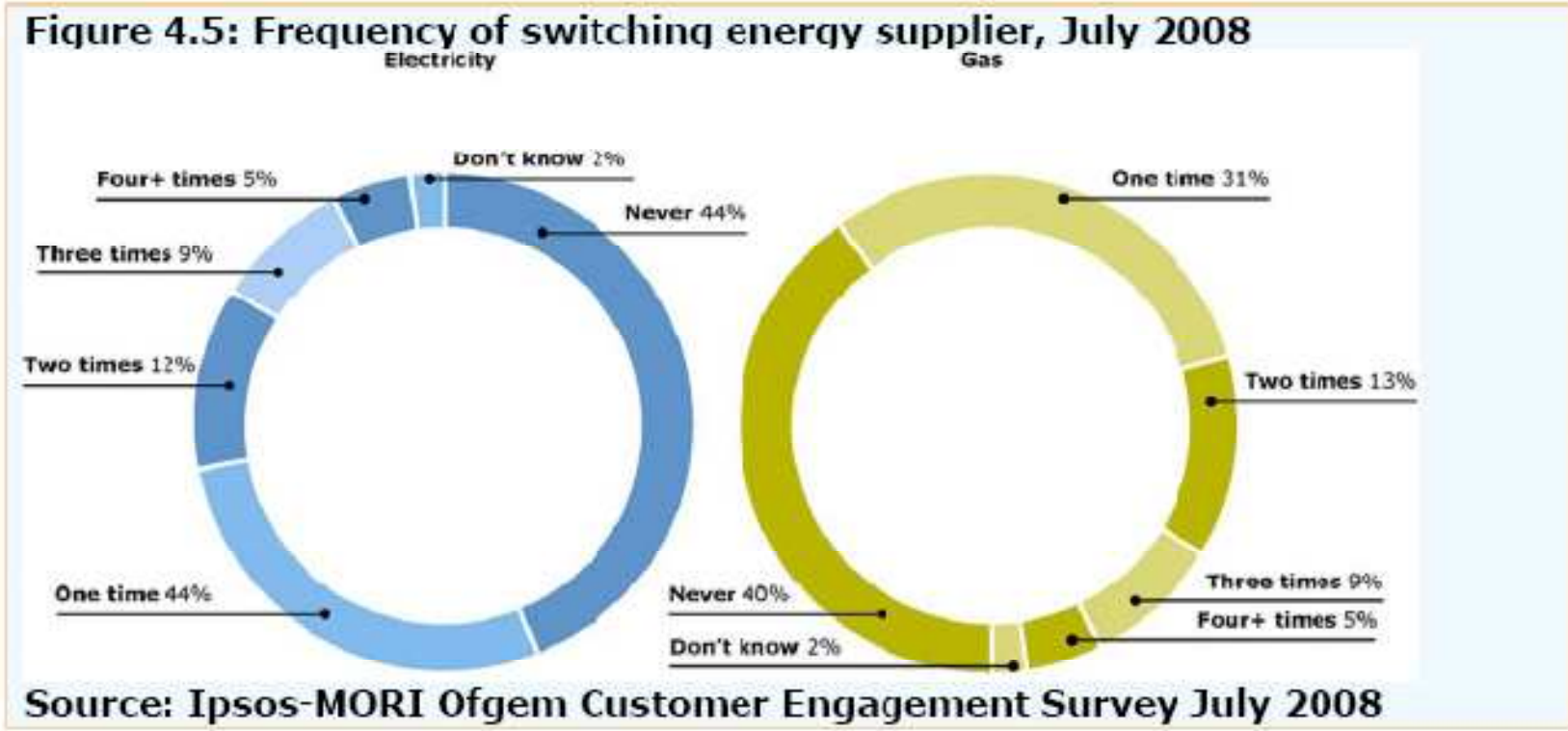
Substantial price gap: Premium of in-area DD over out-of-area DD



Source: Ofgem 2009

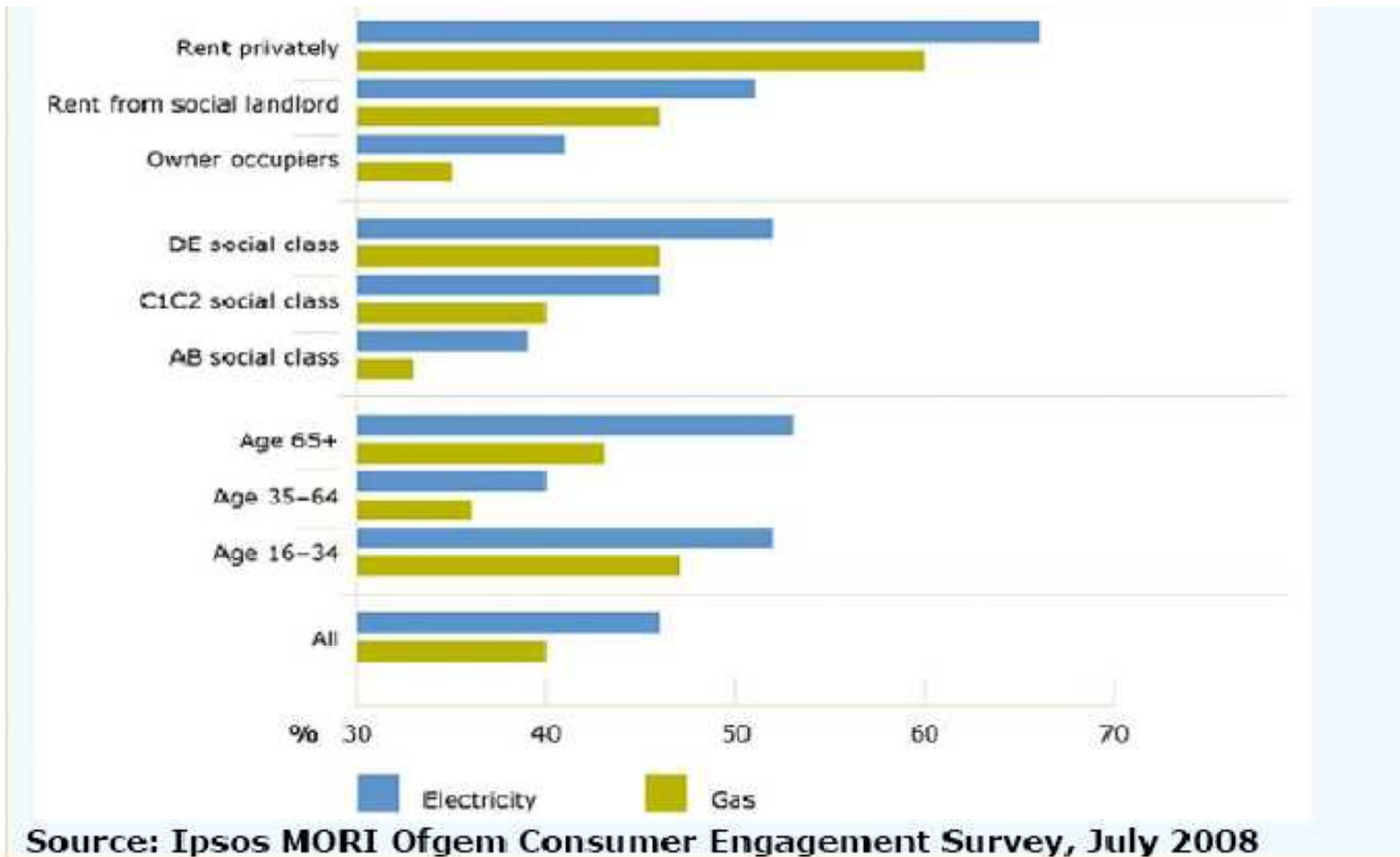
Since incumbents could charge a persistently higher price, they must retain the loyalty of a substantial group of consumers

40% have never switched electricity supplier, 44% gas



Who are these non switchers?

'Vulnerable' consumers over-represented amongst non switchers



And were paying more...

In area premia for standard credit payment

	2003- July 08	Oct 2008	May 2009	Sept 2009
Average	10%	6%	5%	0?
Range	5-18%	2-11%	0-9%	0?

Ofgem, updated for 2009

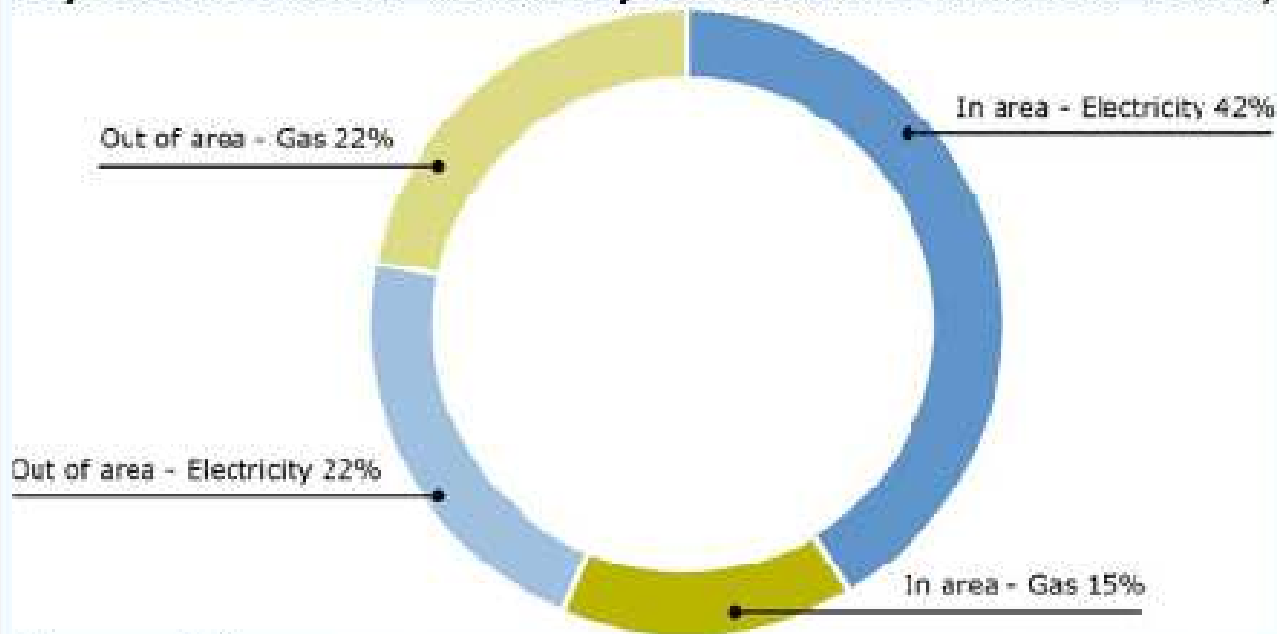
Until the non discrimination clause,
introduced last week

Non discrimination clause: a) immediate effect

- ✦ Prevents companies charging more (relative to costs) in home region
- ✦ i.e. can no longer charge less out of region
- ✦ If immediately revenue neutral, requires prices in area to fall and out of area to rise

Suppliers' customer bases remain mostly where formerly incumbent

Figure 3.8: Former electricity incumbents' customer bases, December 2007



Source: Ofgem

Twice as many electricity consumers 'in area', so prices out of area rise more than they fall in area

Percentage of vulnerable consumers with each supplier

From 2005 Survey of 2027 consumers

Vulnerable group	Incumbent	British Gas	Entrants
Over 65	46	28	26
Low inc	47	31	22
Disabled	44	28	28
Rural	60	20	20
Low educ attain	52	27	22
At least one	47	29	24

More vulnerable consumers will gain than lose from immediate rebalancing (but gains will be smaller than losses, and errors of inclusion and exclusion)

Responses in the market

- ✦ Acts as a ‘most favoured customer’ guarantee: promise that all customers treated ‘equally’
- ✦ Reduces pressure on incumbent; less incentive to switch
- ✦ If incumbent loyalty big enough, entrants will exit: all prices (incumbent and British Gas) increase
- ✦ If entrants remain, the incumbent price will be lower and the entrants and BG prices higher (so majority of vulnerable consumer lose, even in the best case)
- ✦ In all cases average prices and profits higher

So why haven't firms done this themselves?

- ✦ Complications of different costs in different regions
- ✦ National presence of British Gas
- ✦ Suppliers genuinely committed to competitive market (potential damage recognised in responses to consultations)
- ✦ Concern that regulator would intervene

Price differences, Competition and Fairness



- ✦ Price differences vital tool in making competition work - which then brings them closer: not vice versa
- ✦ Forcing uniform prices harms competition
- ✦ May help more vulnerable groups than it harms in the very short run
- ✦ In longer run average prices increase, probably for all consumers
- ✦ Increase in market power and profits may require renewed price caps

Regulator's preferences

- ✦ Ofgem's actions reveal very strong preference for immediate 'fairness' for vulnerable at expense of longer term competition and lower prices
- ✦ Alternative concept of fairness: those who switch (and 'make the market' for all) gain more benefits
- ✦ Many good initiatives to help consumers, especially vulnerable, make better choices - just as the incentives/benefits will disappear through 'uniform' prices
- ✦ Part of a wider backlash against unregulated markets?