

Assessing the competitiveness and efficiency of the Victorian energy retail market.

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November 2019

The retail energy market in Victoria has been open since 2002 with prices deregulated in 2009. Each supplier was required to maintain a standing offer which was paid by those who did not switch to an alternative (market) offer and which included some provisions which may increase their cost. Although many new companies entered the market and 94% of consumers had switched provider or tariff by the end of 2018, concerns remained about the dispersion of the offers available on the market, and the relatively high price of the standing offers. As energy price levels continued to rise, the Victorian government commissioned an Independent Review of the Electricity and Gas Retail Markets which reported in 2017. In its response the following year, the Victorian government replaced companies' obligation to provide a standing offer with one to offer a basic service offer, whose price would be below a level (the Victorian Default Offer) which was to be determined by the Essential Services Commission (ESC). The ESC was also required to "monitor and report on the competitiveness and efficiency of the Victorian retail energy market" and to provide a framework for doing so by the end of 2019. This short paper considers some questions associated with this duty, largely from the perspective of household and small business customers in the British energy market, which has undergone similar changes in the last three years.

1. What would you expect to observe if the Victorian energy market was operating competitively in terms of outcomes for household and business customers?

Competition is a means to an end rather than an end in itself, and can be a powerful tool if used appropriately to deliver better offers and outcomes for most consumers. It effectively aggregates diverse consumer preferences, while not necessarily delivering good outcomes for all. Competition cannot operate without some differentiation between offers, but the process of competition may result in prices which converge, depending partly on how consumers react to the different offers available. Since markets are generally not static, but experience repeated disruptions, such as changing costs, entry and exit and shifting consumer preferences and behaviour, we would not necessarily expect to see equal prices in a real world market which was operating competitively. Moreover it may not be efficient to have equal prices, even in equilibrium. Energy retailers need to recover fixed costs, and the most efficient way to do so is from those consumers whose demand responds least to the consequent increases in price. This is discriminatory in the sense that the proportion of costs recovered depends on the demand responsiveness of the customer, and not merely on the costs of supplying them.

Outcomes for customers can be identified in a number of ways. Traditional economic models have defined these in terms of the price and quality which are available to customers. But with increasing understanding of consumer behaviour, and how customers behave differently from their text book avatars, outcome has come to refer to the prices and bills which are paid. This carries a danger of narrowing the focus too much, since there are many reasons why people may not take advantage of the lowest price on offer¹. It may be helpful to think of these in positive and negative terms. On the positive side, a market may

¹ Papers by Waddams Price and Zhu (2016a) and Flores and Waddams Price (2018) emphasize the heterogeneity of consumer decisions in energy market participation

be operating competitively and producing good outcomes for customers if they have access to all necessary information, even if they choose not to study or act on it, perhaps because they prefer a particular offer, system of billing, certainty about bills, or a quiet life. In other words the choice reflects the customers' preferences. More negatively, if they do not take advantage of better offers because of obstacles, either intrinsic to themselves or their situation or imposed by companies, they are exhibiting barriers to realising an informed choice, and so the higher prices and bills would be at least partly a symptom of the market not functioning well. Switching rates do not record whether consumers made a 'welfare enhancing' choice, and poor choices do not indicate a well functioning market². Thus the outcomes, whether measured in terms of offers or realised bills, need to be interpreted in terms of other conditions in the market. This assessment will be helped by many of the other changes in the energy market inaugurated by the Victorian government, for example on fairness (recommendations 4A to 4E), which address the barriers and obfuscations which are likely to be detrimental for customers.

One complication in interpreting a wide dispersion of prices is that they may represent a positive response to consumers' different preferences and behaviours, in terms of different forms of tariffs. Such tariffs may enable customers to choose the tariff which is best for their particular pattern of consumption; but when these are aggregated using a single consumption pattern, they may result in widely different aggregate prices. This may reveal welcome innovation rather than an ineffective market, depending on customers' ability to choose the best tariff for themselves.

Assessing outcome in terms of prices and bills paid, rather than those on offer, raises further questions about different groups of customers. Much recent criticism and unease with the competitive process in energy markets arises out of a suspicion that it delivers good outcomes only for a privileged few. As noted above, some customers may have apparently less good outcomes because of choice or preferences, and the process of competition does not guarantee particular outcomes to any particular groups. Competition generally puts downward pressure on the average level of prices, but may leave some groups paying more. The ESC and the Victorian Government may need to use other tools if they are to work with the grain of the market, while ensuring particular outcomes for some groups. One possibility would be the use of collective switching, inviting competition *for* supplying a particular group, rather than direct competition *in* the market itself³. The presence of a price cap which affects the market is itself likely to complicate the assessment of the market. In particular it may be difficult to assess how the market would operate if the cap were removed⁴.

Price is not the only relevant dimension, even with a product as homogeneous as energy. There may be particular preferences, for example for paper based bills, which are more expensive than other routes, and it is important that focus on price, and the introduction of a price cap, does not result in reduced choice. Where higher quality is more expensive to supply, there is value in signaling this through price differentials, so that customers can make an informed choice. But if particular groups of customers, for example the visually

² Wilson and Waddams Price (2010) reported that in the early days of competition in Britain, between a quarter and a third of electricity switchers changed to a deal that was worse according to their own criteria; Hviid and Waddams Price (2014) have discussed well-functioning markets in the energy context

³ See Deller et al., 2017a for a report on experience and potential for collective switching.

⁴ Deller et al. 2017b discuss issues around removing the British price cap.

impaired, need different services, it may be appropriate to subsidise these from general funds.

Markets are traditionally judged by observed transactions, but customers' perceptions of their experience can also indicate that they are working well. However customer sentiment is affected by their broader views of both markets in general and their expectations of energy markets in particular, so dissatisfaction may not arise directly from the market itself. To provide useful information about how the market is working (rather than whether it is a good idea in principle, for example) consumers' views need to be focused on specific aspects and interpreted in the wider context of their expression

2. What is your view on the Victorian market's performance and how does this compare to other markets?

From an external perspective, the Victorian market's performance compares favourably with that of other liberalised energy markets on several measures. In particular, having only 6% of customers on the Standing Offer after seventeen years of choice (and a decade of fully deregulated prices) is an impressive figure, particularly since these standing offers retain particular features which some customers may prefer, and some customers are likely to pay this rate only temporarily. While not directly comparable, about half of British consumers were eligible for the default tariff price cap in 2019⁵, because they had not switched energy supplier or tariff in the previous four years. Consumer participation in the Victorian energy market therefore appears to compare well with that in Britain.

Another favourable factor in the Victorian market is that customers on hardship schemes, who have particular affordability challenges, are more likely to be paying through market offers than on the more expensive standing offers⁶. This may partly be the consequence of advice which is received via the hardship programme itself, a good example of interaction between general income support and assistance in the energy market. However the ACCC (2018) notes that in other Australian jurisdictions some other potentially vulnerable groups may be overrepresented among the standing offers. This would reflect the situation in Britain, where a higher proportion of many potentially vulnerable groups are less active, in particular those who are young and very elderly (younger pensioners are often among the more active groups) and those with lower income or are classified in lower social categories. While those with affordability pressures may have more incentive to seek out the better deals, it appears they face barriers of time, cognition or opportunity in exercising such choices⁷.

However the quality of customer decision making in Victoria, in terms of achieving the best deal, or at least a reasonably good deal, in the market may be more questionable. The variety of tariffs and discounts available make choosing the best tariff a more complicated process than for most British consumers, partly because of greater innovation and choice. The moves to standardise offers are welcome insofar as they enable more welfare enhancing choices by consumers, but they may lead to a reduction in choice (and welfare) for some consumers. Strengthening this aspect of consumer protection in terms of requiring clear information which is not misleading is an important part of encouraging the market to work well. However the response of retailers to new constraints and requirements for

⁵[GFK, 2018](#)

⁶ ACCC, 2018.

⁷ GFK, 2018.

greater transparency may result in unintended consequences. In the British market, both the regional non discrimination clauses and the restriction in the number of tariffs which each retailer could offer, led to the softening of competition and subsequent criticism from the Competition and Markets Authority⁸.

Many of these interventions in Britain were introduced because of dissatisfaction with both the level of energy prices and their dispersion, so that switchers realised significant gains compared with prices paid by those who were inactive in the market. A market investigation by the Competition and Markets Authority (2016) resulted in a British regulator-determined cap on prices paid by the 15% of consumers using prepayment meters in 2017. In 2019 a more widespread and controversial cap was introduced following government legislation, for another half of all residential consumers, who had not recently switched and were paying a default tariff. Both these price caps led to an initial reduction in price dispersion, and the removal of some ‘worst’ and ‘best in market’ offers (Ofgem, 2019a). When the level of the cap was raised after four months, the large (previously incumbent) suppliers raised their regulated tariffs by a similar amount, to within £2 of the new cap. However price dispersion increased to previous levels a few months after the default cap was introduced, and reached £350 (28% of the capped price) in June 2019. The regulator attributed this to falling wholesale prices, which led to heavy discounting, especially by newer entrants, with default tariffs staying largely stable and close to the cap. Switching rates increased to historically high levels, despite predictions that a cap would suppress them.

3. What sort of innovation would we hope to encourage in a competitive market?

Innovations are by definition difficult to predict, and one great strength of competition over regulation is that the market will produce innovations which regulators cannot identify, let alone introduce. These arise from the market knowledge, imagination and legitimate self interest of retailers, and while many innovations are welfare enhancing for consumers, not all benefit all consumers. Regulators should ensure that they are not impeding any potentially beneficial innovation, and that innovation does not unduly harm consumers, either as a group or subgroup. This requires monitoring and analysis of new practices.

One area in which the Victorian market has already shown considerable innovation is in tariffs, where a wide range of tariff types is available, with considerable choice for consumers. However such choice can also be a cause for concern if it results in obfuscation and difficulty in customers identifying the best deal. Another area of innovation is technical, in particular the introduction of smart meters, which enable both a greater variety of tariff offers, and more information for the consumer to take advantage of the type they prefer. Similar possibilities arise from smart appliances and other tracking and control devices.

Technical innovations in small scale and community generation and storage could deliver considerable benefits to individual consumers and to the system as a whole. Data innovations, for example data portability so that consumers can use information about their own consumption to obtain accurate quotations from other suppliers and tariffs, may also enable the market to work more smoothly. But many of these depend for their effectiveness and benefits on customer activity, and we have seen that this has been rather disappointing in energy markets, for understandable reasons. It may be that automating or delegating responses will enable benefits to be delivered without depending on real time consumer involvement.

⁸ Hviid, Waddams Price and Minyan Zhu showed that the British regional non discrimination clauses reduced competitive pressure (Hviid and Waddams Price, 2012; Waddams Price and Zhu, 2016b); and the Competition and Markets Authority criticized both these regulatory policies in its 2016 report (CMA, 2016).

A distributive problem may arise if some groups of consumers are better equipped or more inclined to take advantage of innovations than others, analogous to variations in switching activity. If some customers adopt new habits, the costs of the system for those who do not may rise in absolute terms, as well as relatively because they are not taking advantage of the new technology. If the customers who are 'left behind' are more likely to be vulnerable, this poses additional issues for the regulator and other policy makers.

Moreover if innovations incur largely fixed costs, there may be a direct tension between encouraging innovation and reducing price dispersion. Discriminatory prices can maximise the total benefit, so that the fixed costs can be recovered and all are able to afford the (low marginal cost) invention, with larger contributions made by those with less responsive demand patterns, as noted above.

One possible innovation is greater bundling of products – for example electricity with appliances, including cars; or gas and electricity as a bundle together and/or with other utilities. The benefits of such bundling are ambiguous. They often provide immediate advantages through convenience or reduced cost (for example via reduced billing costs); but they may also pose new competition issues if they enable dominance in one market to be leveraged into another. Like many innovations, this will require regulatory analysis of the welfare benefits, the extent to which they are shared with all or some customers, and any adverse distributional effects.

4. What measures would you use to undertake your assessment?

Because competition is a process, and a means to an end rather than an end in itself, its assessment should be multifaceted, capturing a range of aspects which would be expected in a well-functioning market. When energy markets were first opened to new entry, the focus was on the supply side, and structural measures remain important. These would include the number of suppliers, market share and concentration indices and evidence that there are no barriers to entry, exit or expansion. Consumer measures may include both engagement indicators such as search and switching rates (between both suppliers and tariffs) and trust and confidence indicators. On the efficiency side, information about the costs of suppliers and their profit levels will be informative. These are broadly the measure proposed by the British regulator, Ofgem (2019b) and could be adapted to the Victorian situation. Ofgem expects to consider a range of indicators, without committing to a particular balance between them, which seems a sensible way to capture an overview of the market and avoid potentially damaging game playing.

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