



# **The unfortunate paradox of retail energy prices**

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Chairperson

Essential Services Commission (Vic)

## Some recent observations

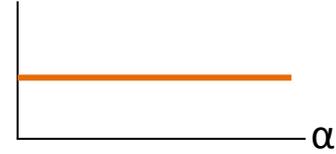
- **Retail contribution to growing bills** (ESC 2013, Grattan 2017, Thwaites et al 2017, ACCC 2017)  
*“This was not the outcome Victorian consumers anticipated from the competitive market” – Thwaites et al*
- **Increasing costs faced by retailers** (Thwaites et al 2017, ACCC 2017)  
*“a great disappointment to everybody” – Rod Sims (3 May 2018)*
- **Competition costs have increased** (ACCC 2017, Thwaites et al 2017, Finncorn 2017)  
*“the ‘hamster wheel’ of roughly maintaining customer numbers” – Finncorn 2017*
- **Bigger discounts & Growing price dispersion** (AEMC 2017, IPART 2017)  
*“Higher levels of price dispersion are often associated with markets with more effective competition” – AEMC 2017*  
*“[P]rice dispersion is not an obvious feature of a competitive market” – Helm 2017*

# The model: Assumptions

- Once consumers engage, they stay engaged (“footloose” vs “sticky”)
- Retailer portfolio of two types of contracts: (1) default and (2) discounted contracts
- Once a customer has switched to a discounted contract, they will stay there.
- Competition is measured by the proportion ( $\alpha$ ) of customers on discounted contracts. The proportion of customers on default contracts equals  $1-\alpha$ .
- Retailers must satisfy a budget constraint (Weighted Average Price = Average cost)
- No inflation (and no time)
- All retailers face same cost function
- Demand is inelastic so change in costs passed through to customers in full
- Prices never exceed their long run values (i.e. no over-shooting)
- Retailers face three types of costs

## Retailers face three types of costs (per customer account):

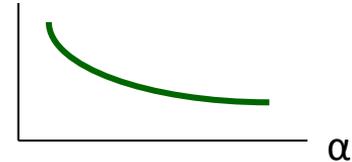
(1) **Non-retail underlying costs** = wholesale, network, 'green' schemes



- these costs held fixed to provide focus on influence of retail costs on prices

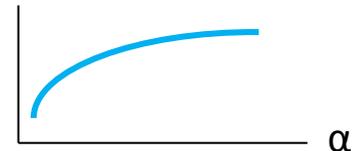
(2) **Retail underlying costs** = costs per customer that decline with the level of competition

- competition-induced efficiency gains (convex function)
- include a share of cost of capital (margins)



(3) **Competition costs** = costs per customer that increase with the level of competition

- diminishing marginal costs to compete (concave function)



# What are competition costs?

Competition costs consist of :

- administrative costs associated with managing customer transfers
- customer acquisition and retention costs (CARC).
- higher capital costs due to the higher risk of operating in an increasingly competitive environment – i.e. the risk of losing market share

The model does not disaggregate competition costs.

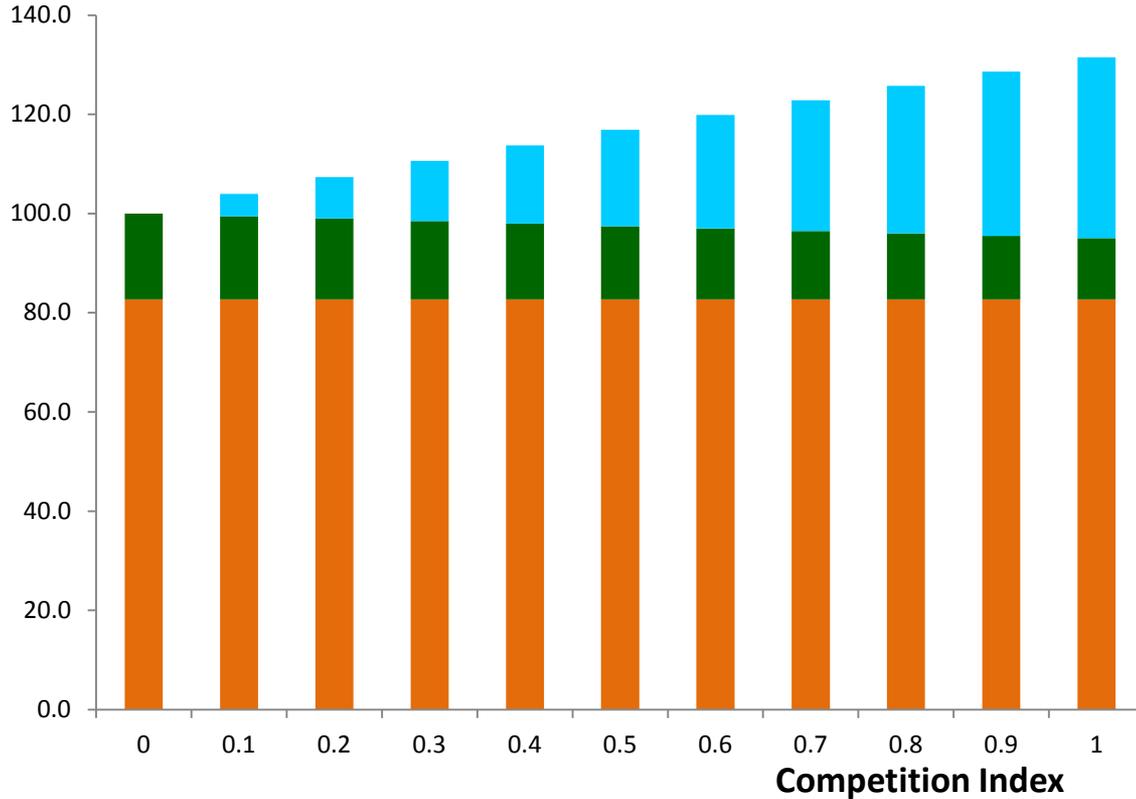
## The model (cont.)

The model is calibrated using outcomes observed in the Victorian retail electricity market (2016-17).

Results are indexed so zero competition implies total costs (and retail price) is equal to 100.

# Costs

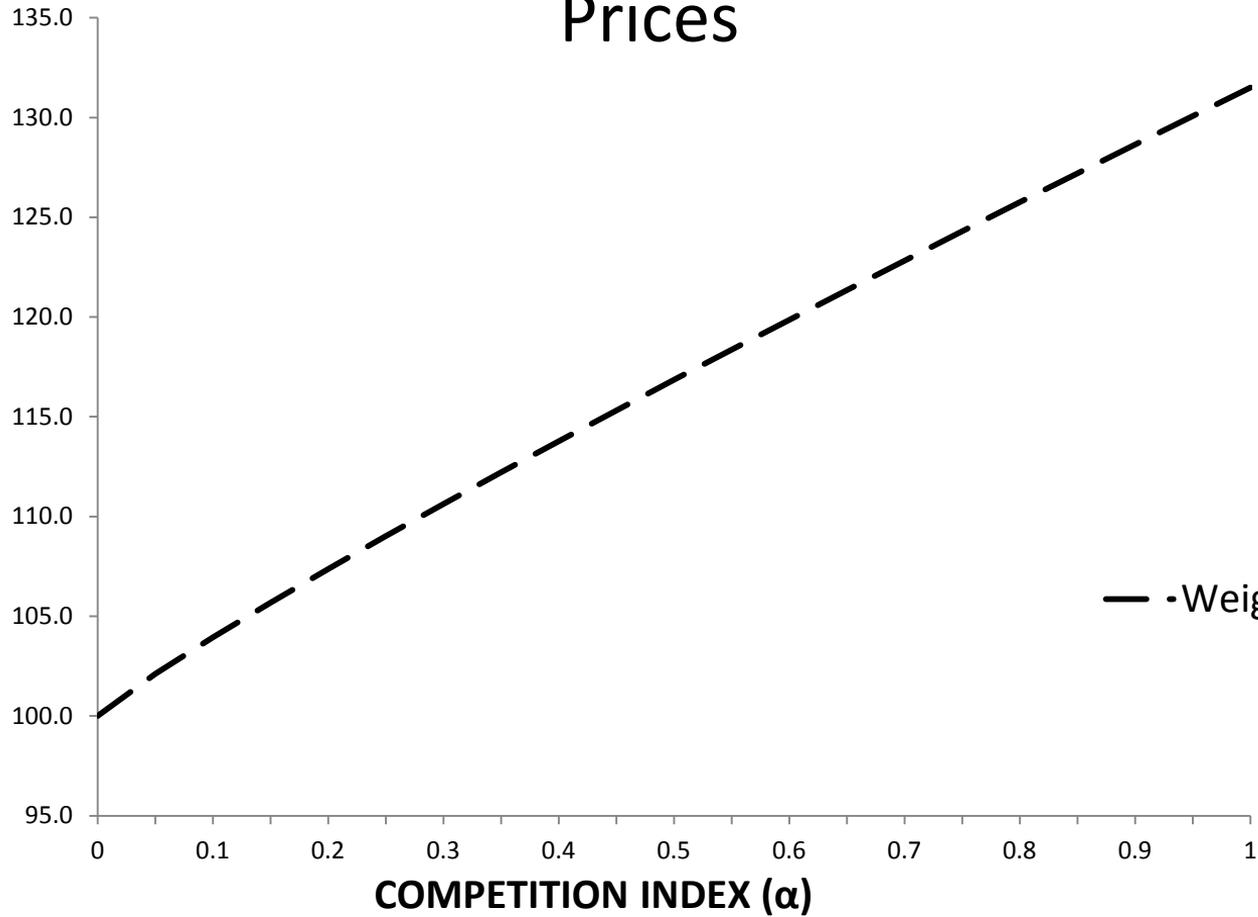
**Cost Index**



- Cost of competing
- Underlying retail costs
- Underlying non-retail costs

# Prices

**PRICE  
INDEX**



— -Weighted average price

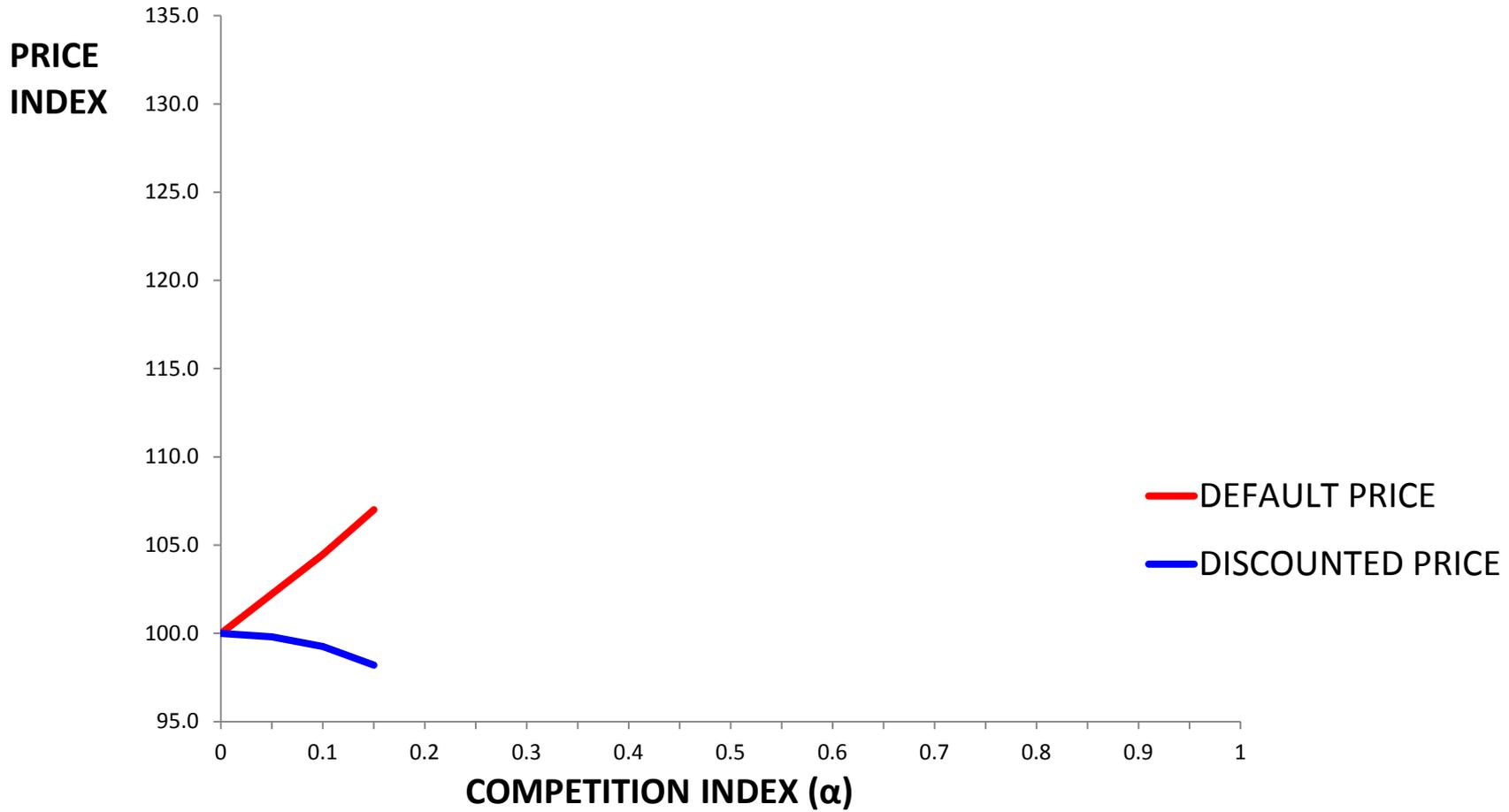
# Full retail competition commences

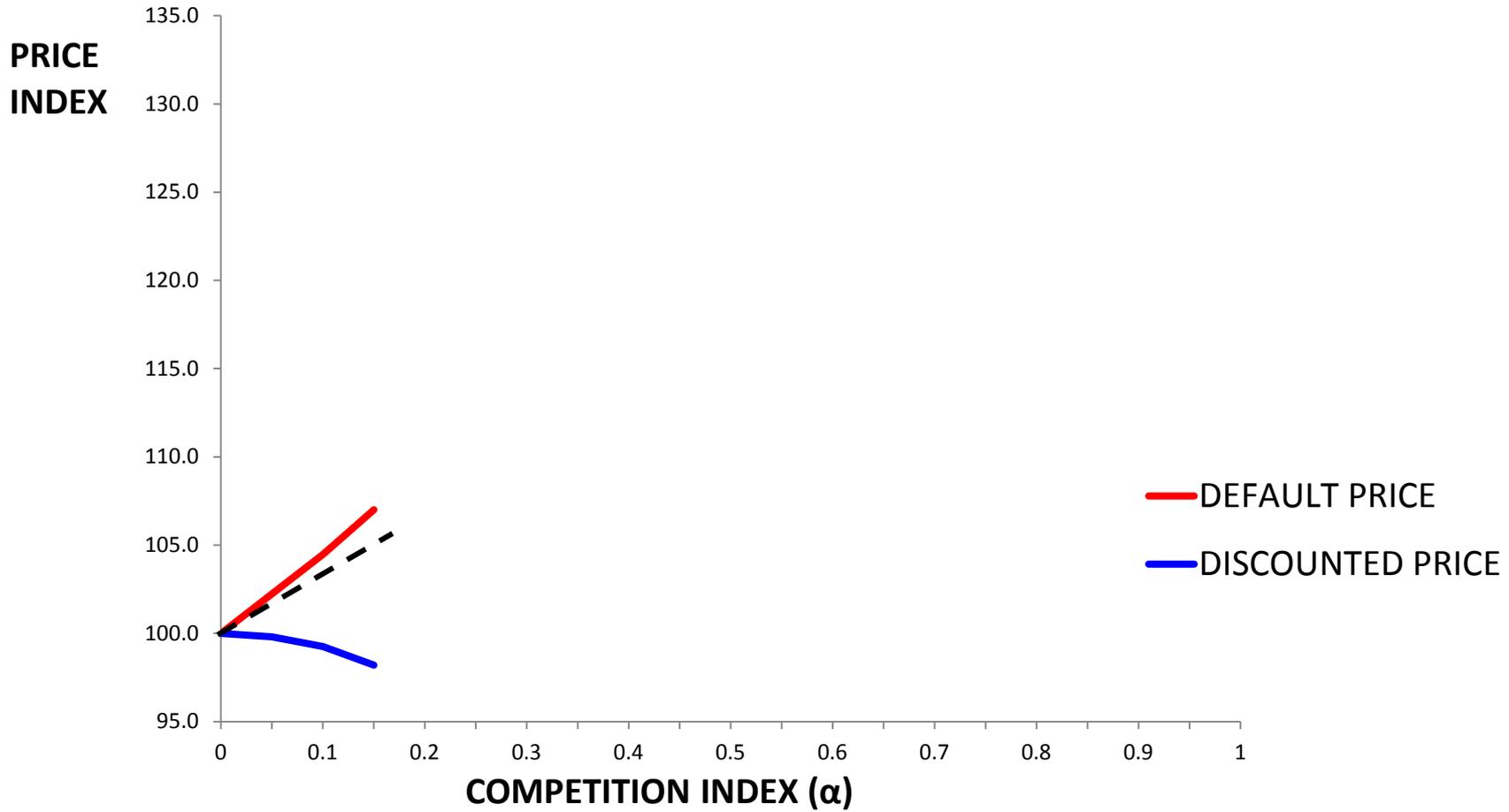
**PRICE  
INDEX**



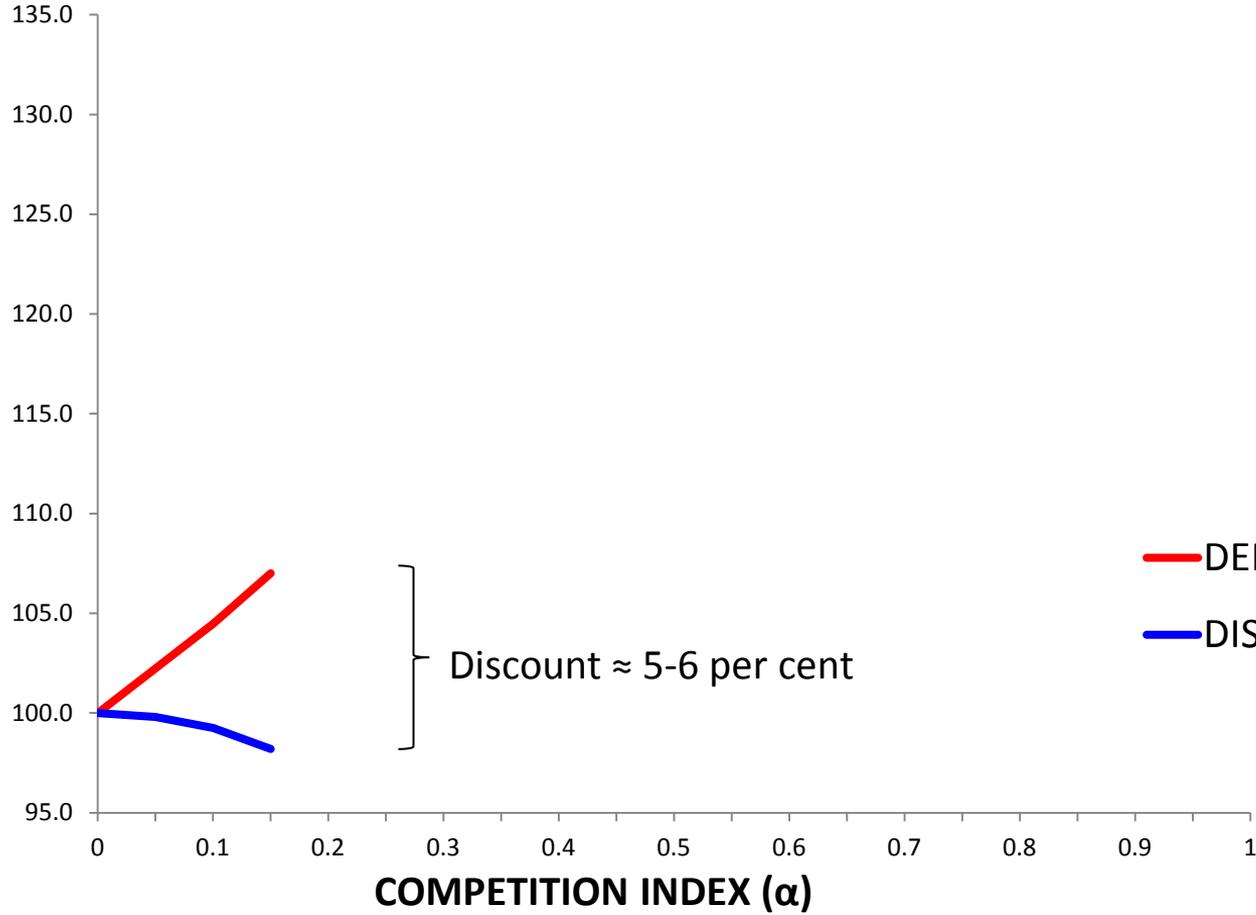
— DEFAULT PRICE

**COMPETITION INDEX ( $\alpha$ )**



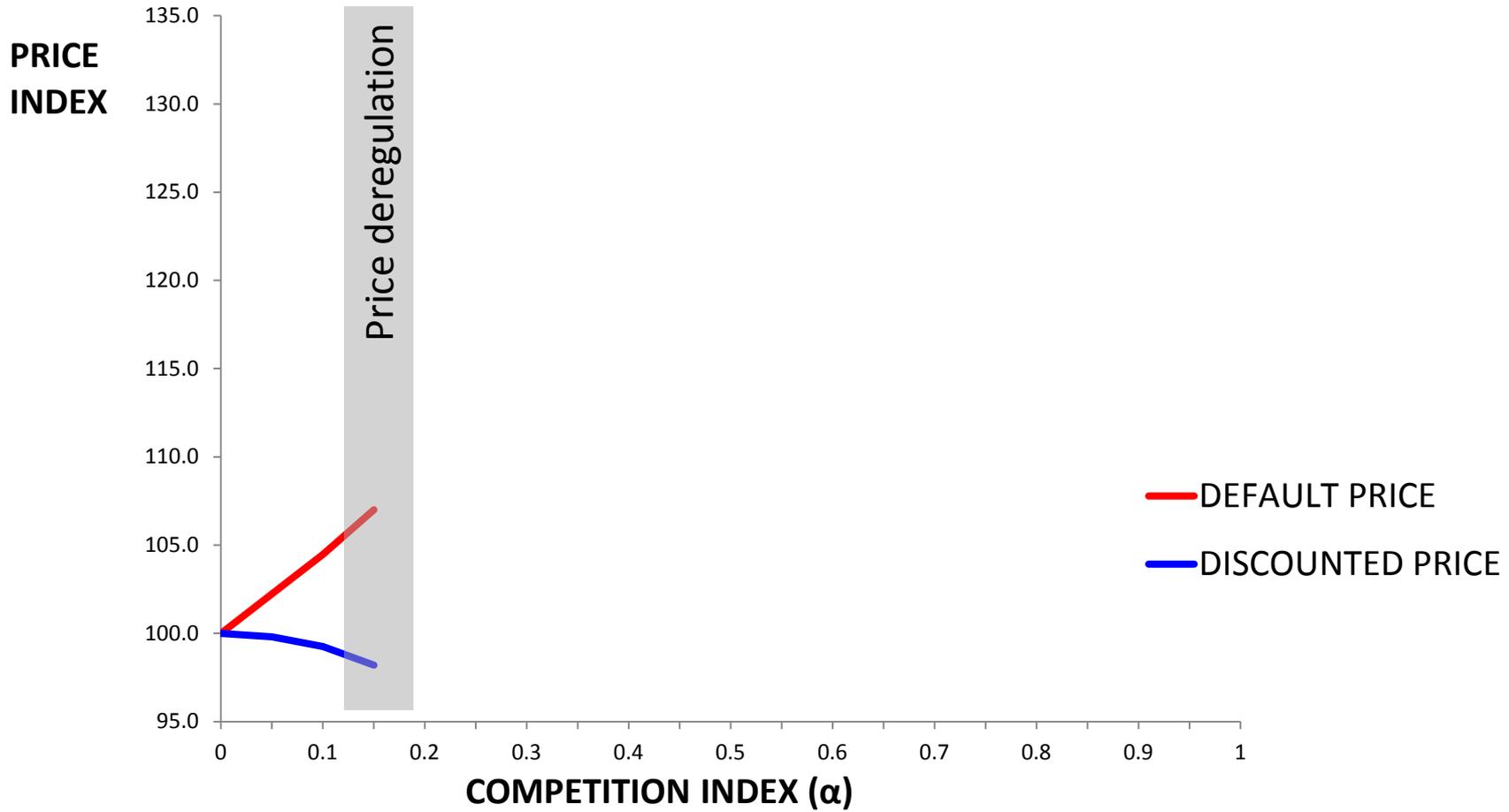


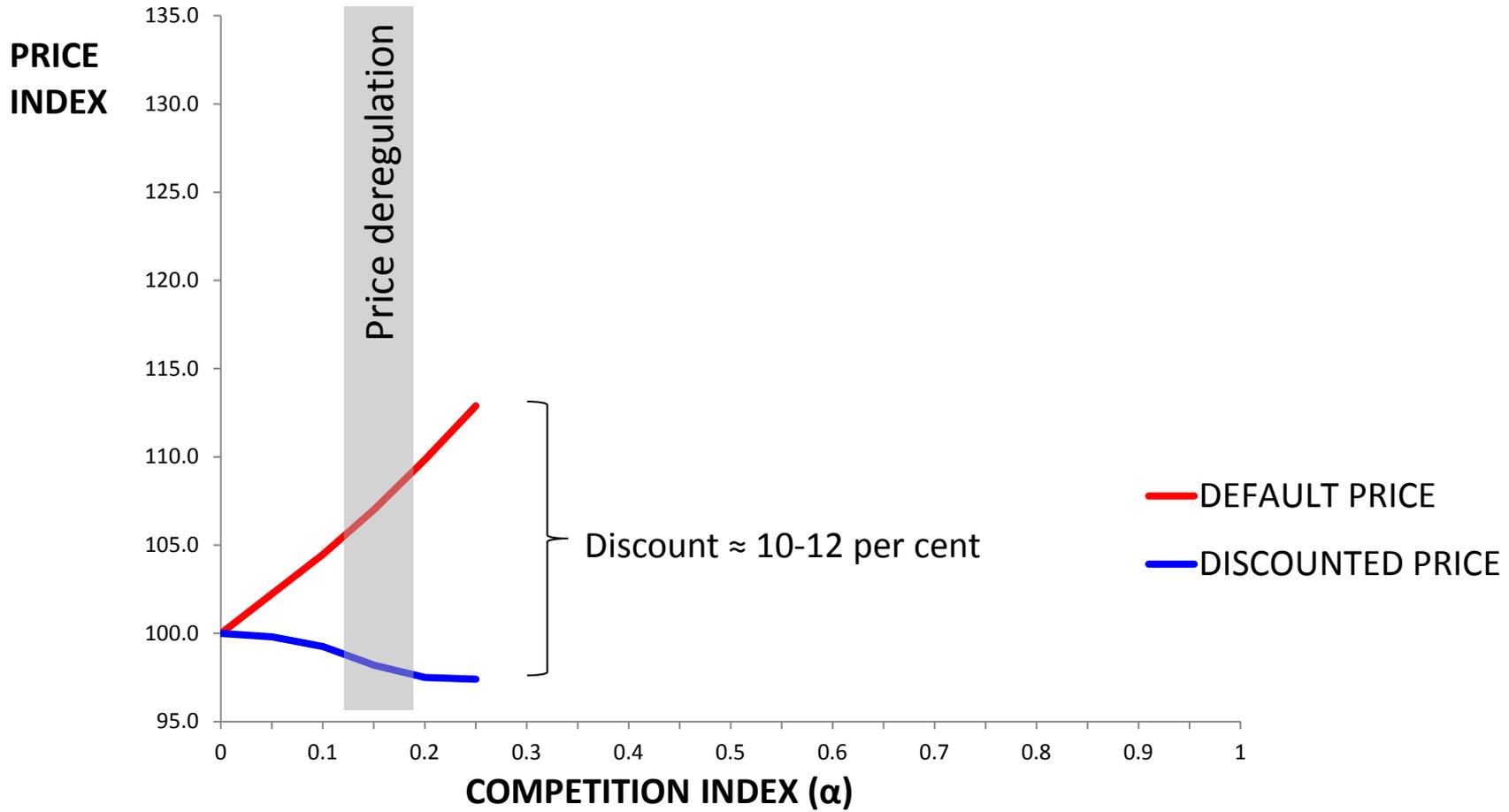
**PRICE  
INDEX**

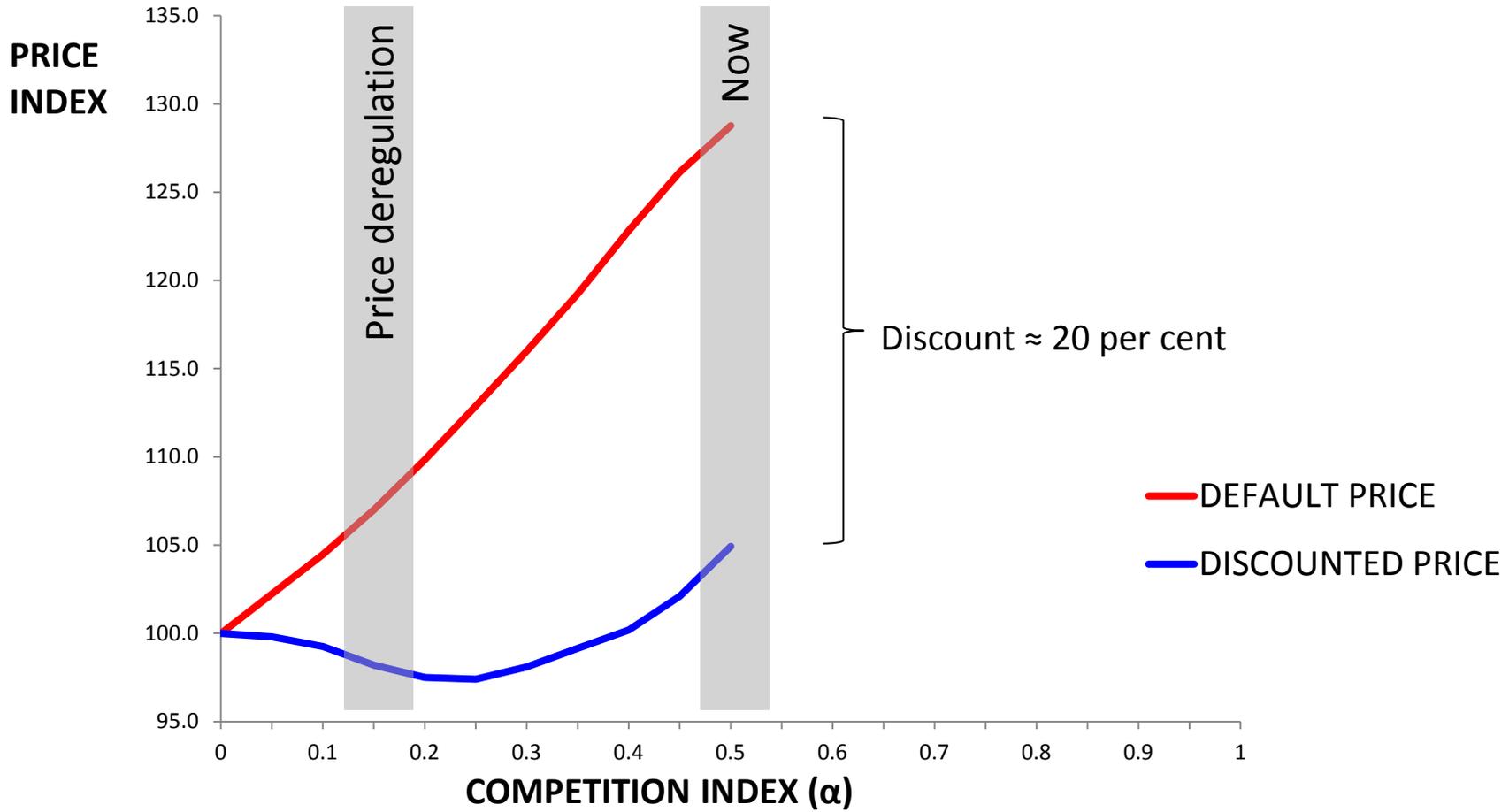


**—** DEFAULT PRICE

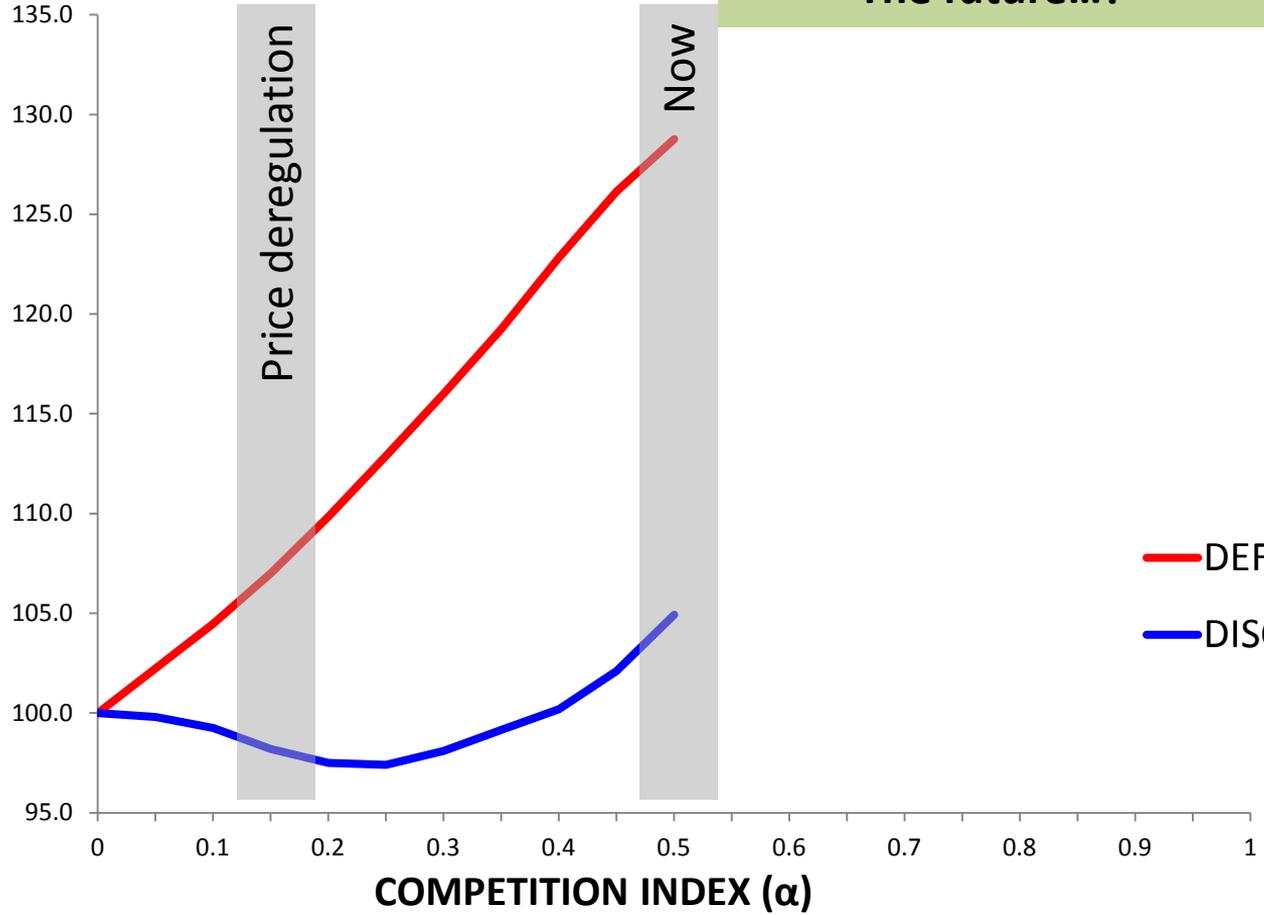
**—** DISCOUNTED PRICE







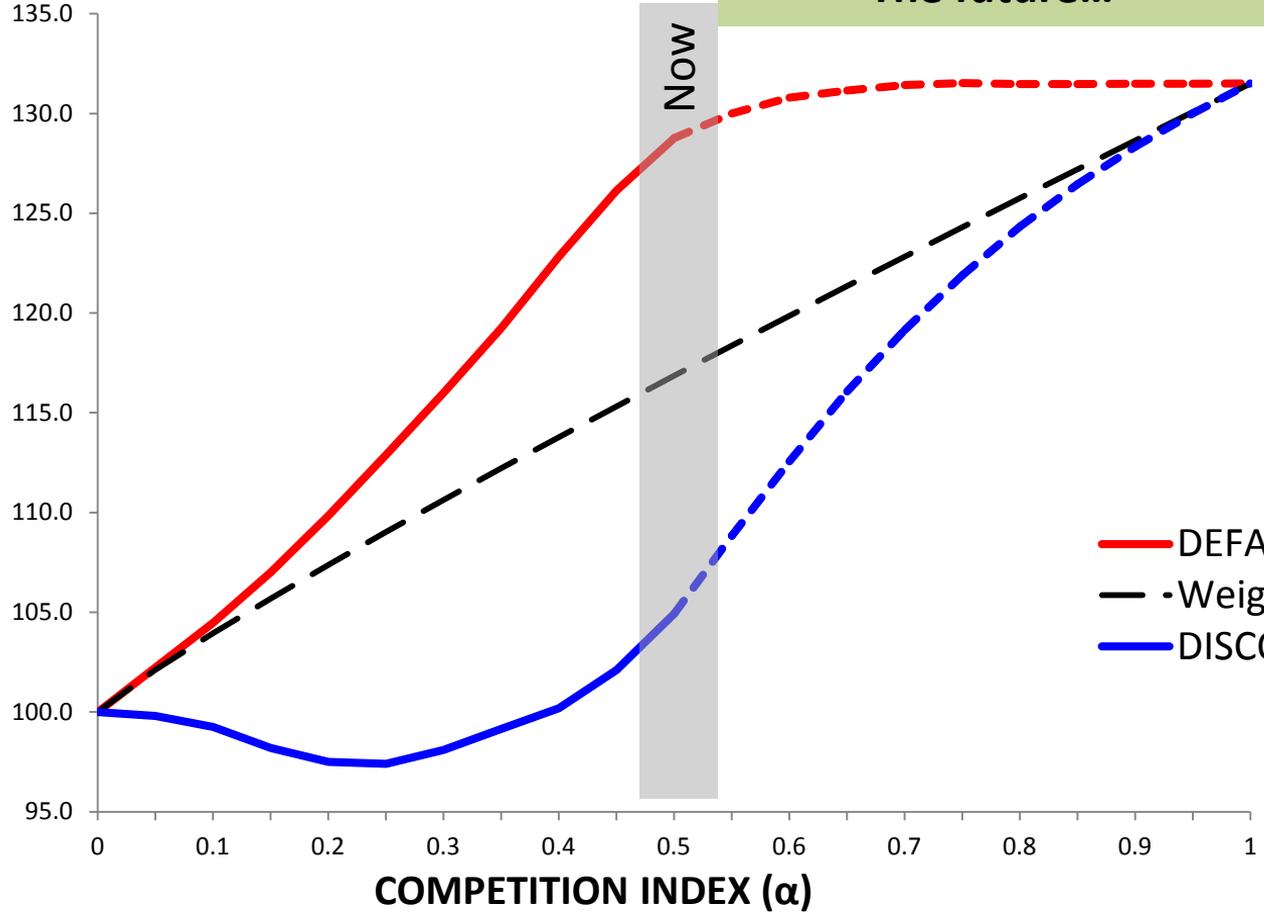
**PRICE  
INDEX**



**The future...?**

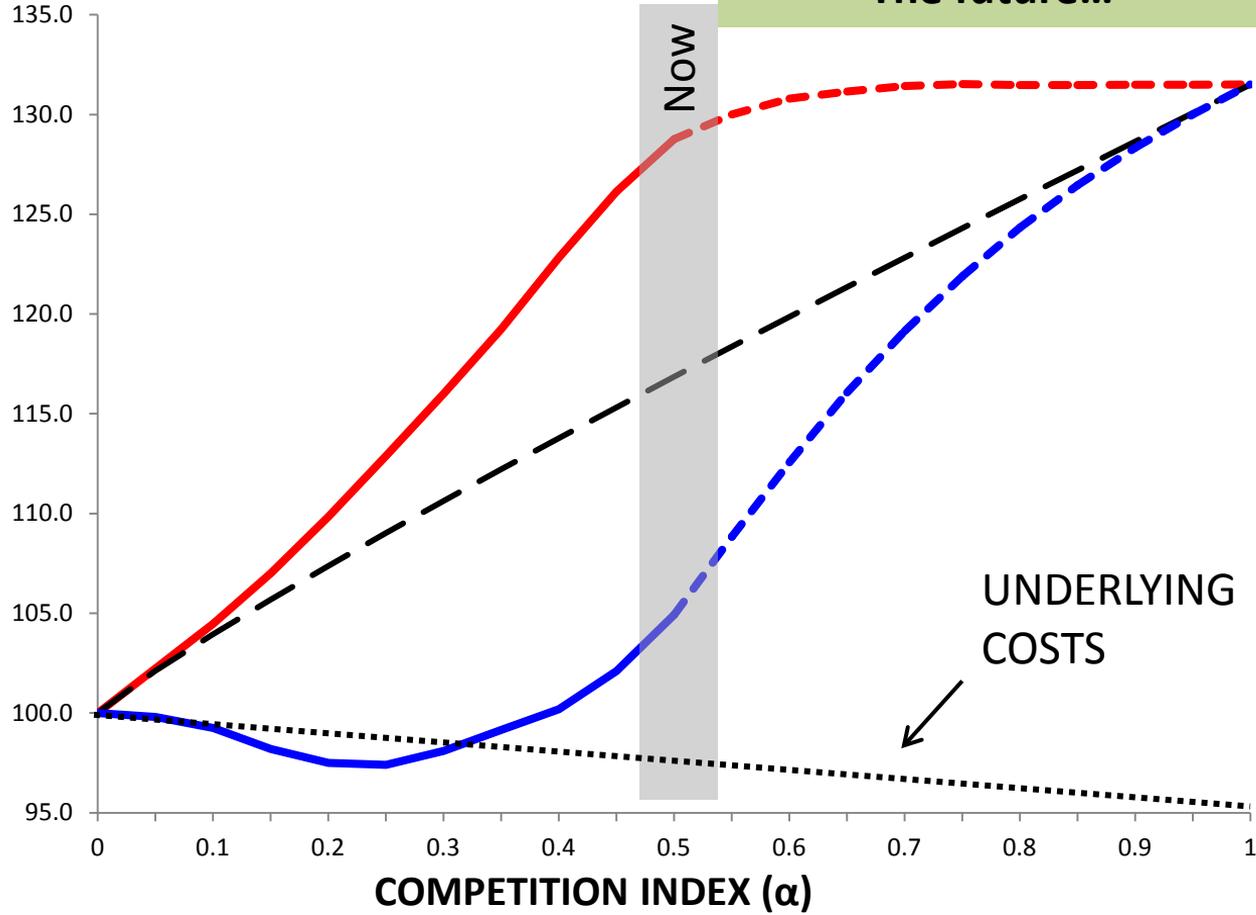
**— DEFAULT PRICE**  
**— DISCOUNTED PRICE**

**PRICE INDEX**



- DEFAULT PRICE**
- Weighted average price**
- DISCOUNTED PRICE**

**PRICE  
INDEX**



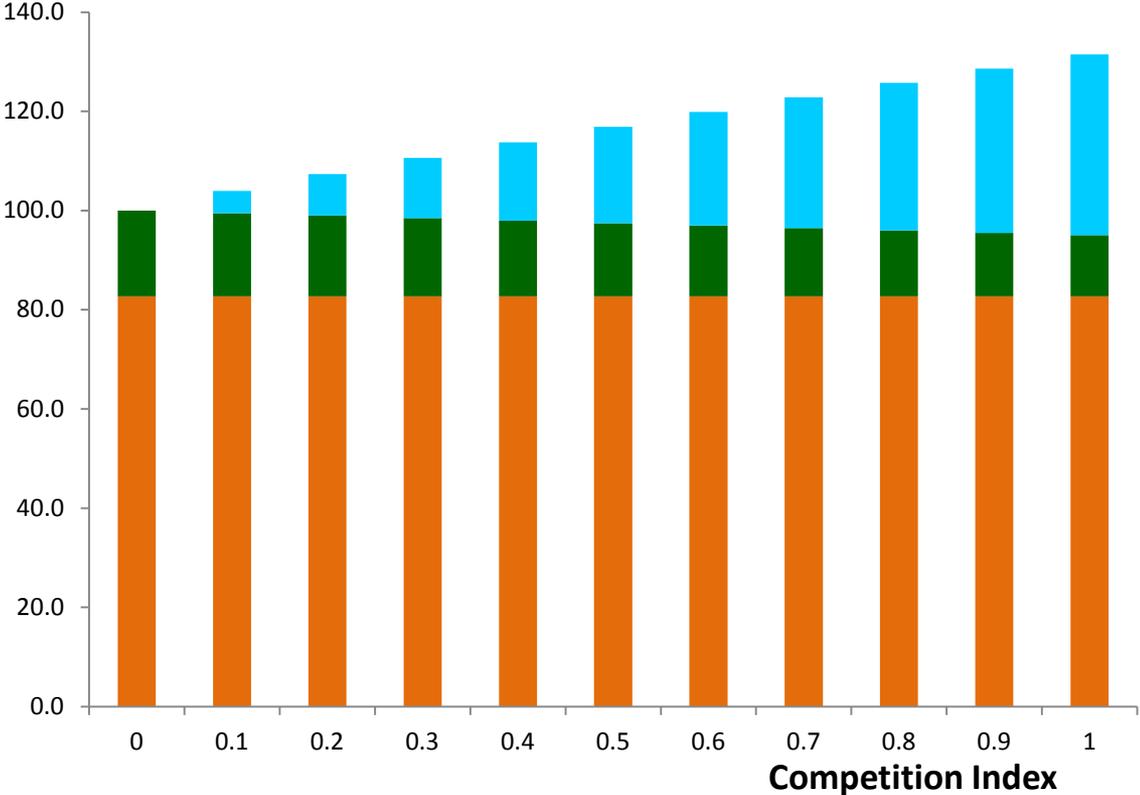
**The future...**

**Now**

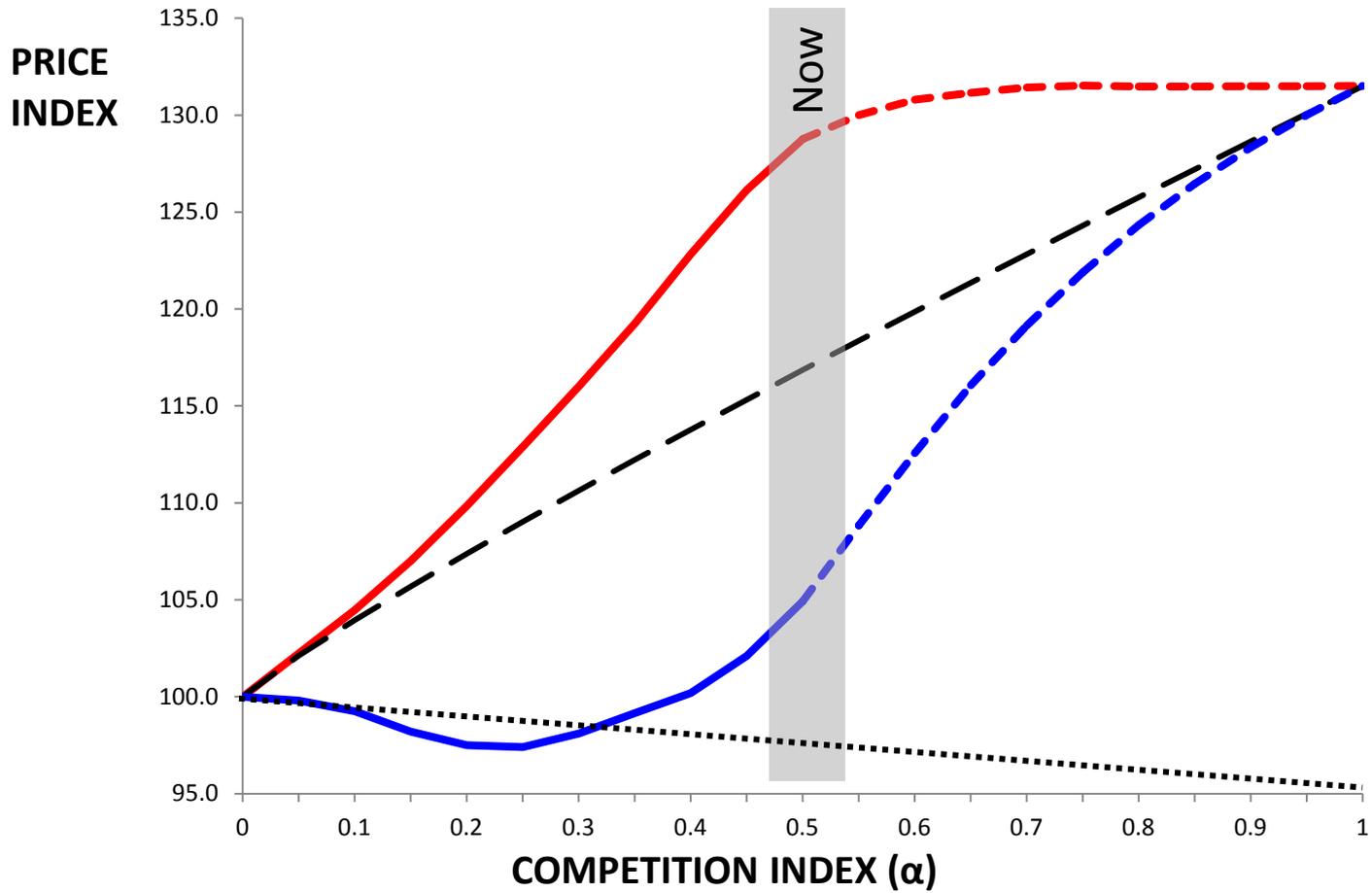
**UNDERLYING RETAILER  
COSTS**

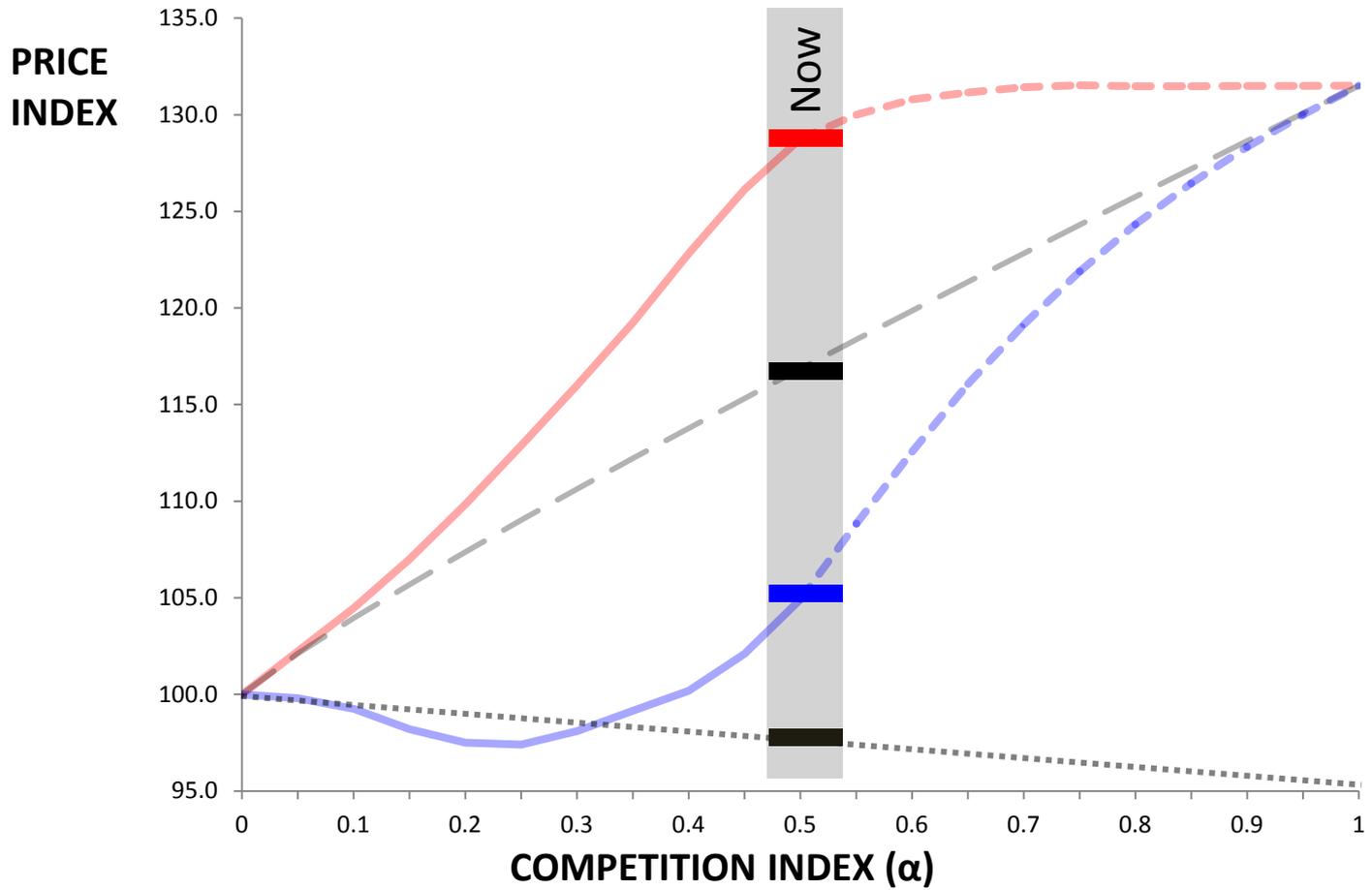
# Costs

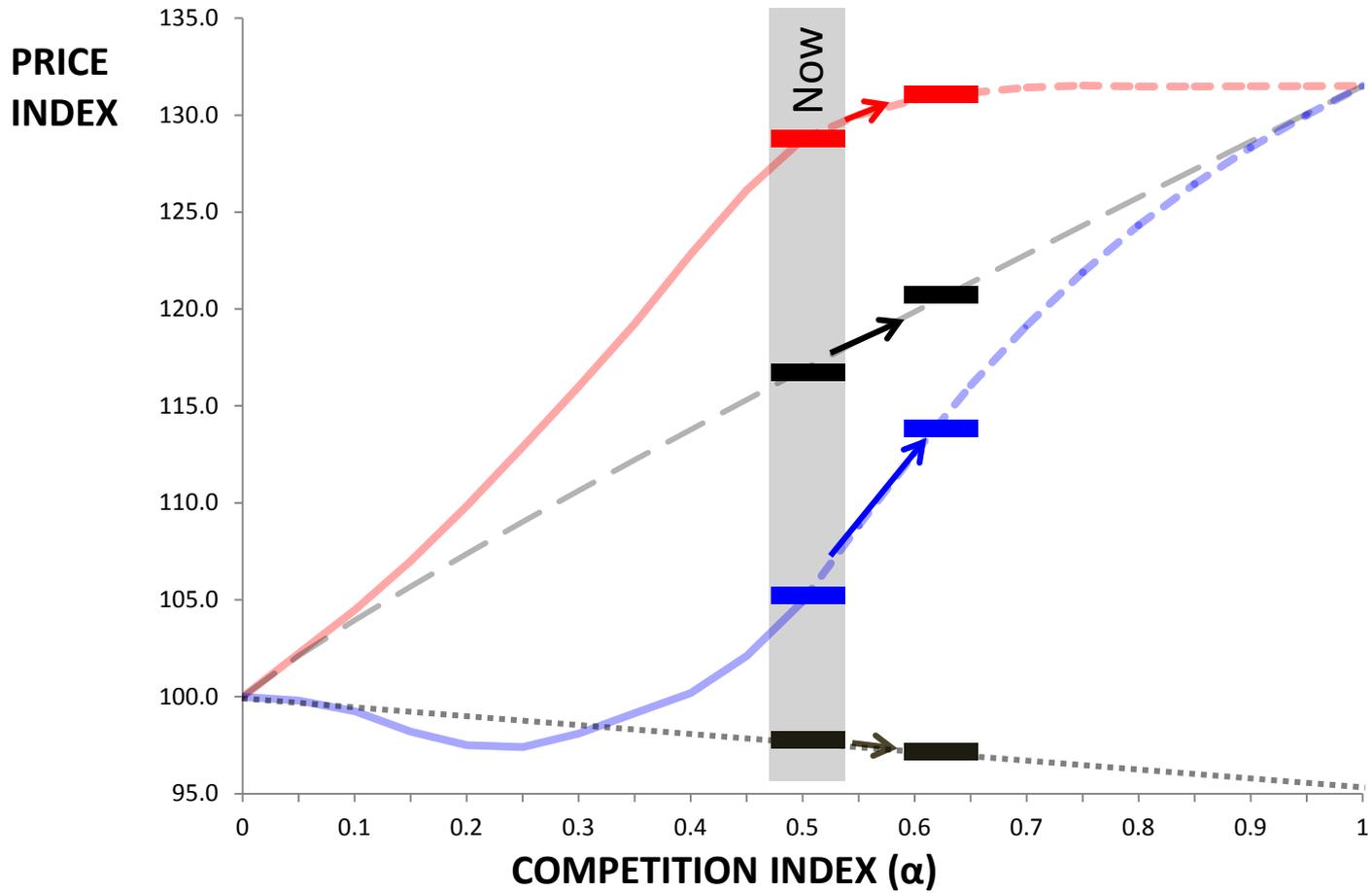
**Cost Index**



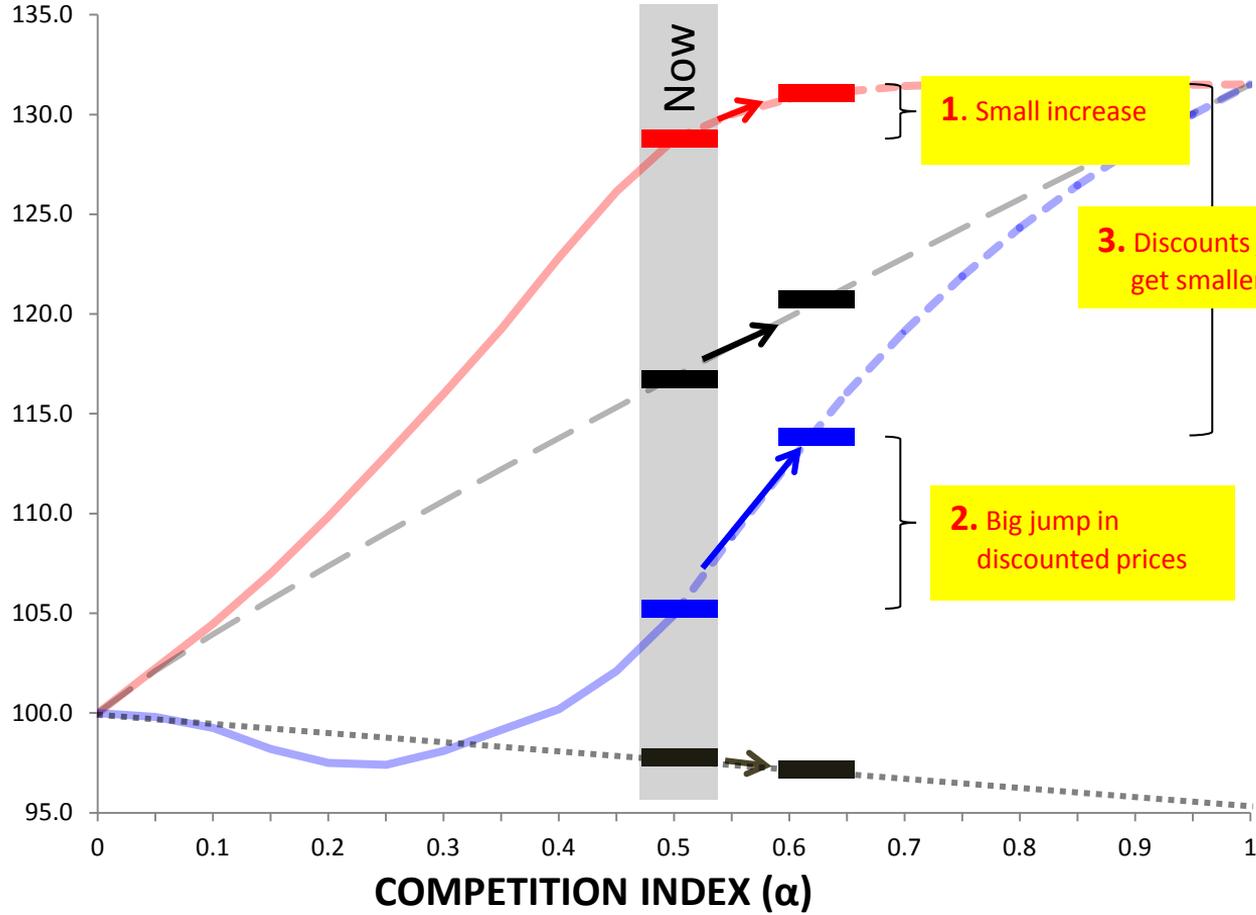
- Cost of competing
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- Underlying non-retail costs







**PRICE INDEX**

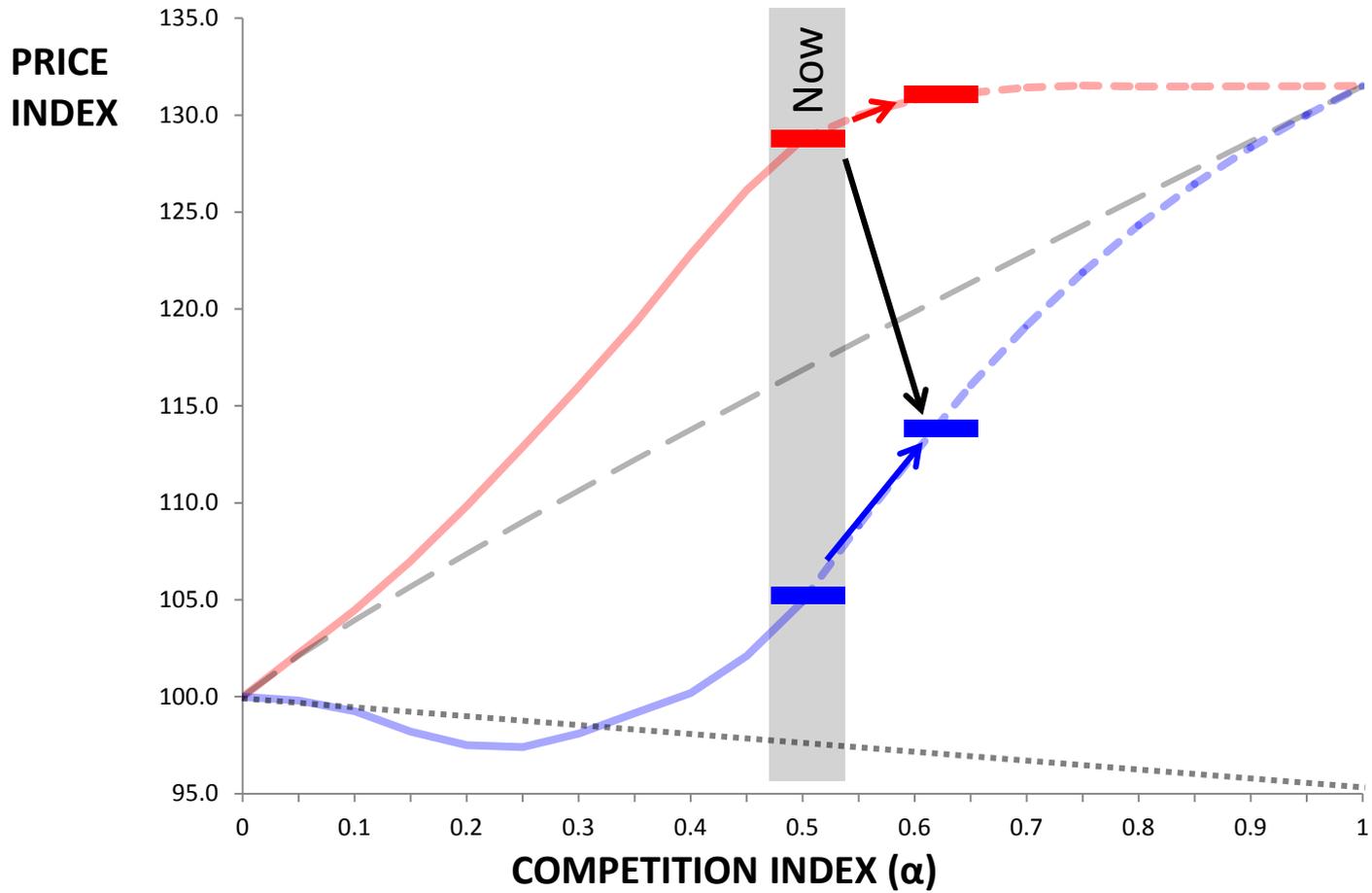


This result is contrary to the usual expectations about the impact of increased competition on retail markets. That's why my paper is titled:

***The unfortunate paradox of retail energy prices***

The paradox is this:

Policy makers and regulators feel compelled to encourage customers on default contracts to shop around. This certainly helps customers who decide to switch but it means prices increase for all other customers (especially customers on discounted offers).



The ACCC has rightly noted the need to:

*“...be mindful of the history of interventions in this market which have too often had unintended consequences to the detriment of energy users.”*

But that does not mean the regulatory community should not act for fear of unknown and unknowable outcomes. The retail energy market is already imposing substantial competition costs on consumers.

*“Competition costs of the scale observed in the (Victorian) retail energy market are the unintended consequence of earlier assumptions about the market.” [RBD]*

Just because the unintended consequences of those earlier assumptions are now longstanding, grants them no special privilege. If they can be lessened at the potential expense of another unintended consequence, that may be a risk worth taking.

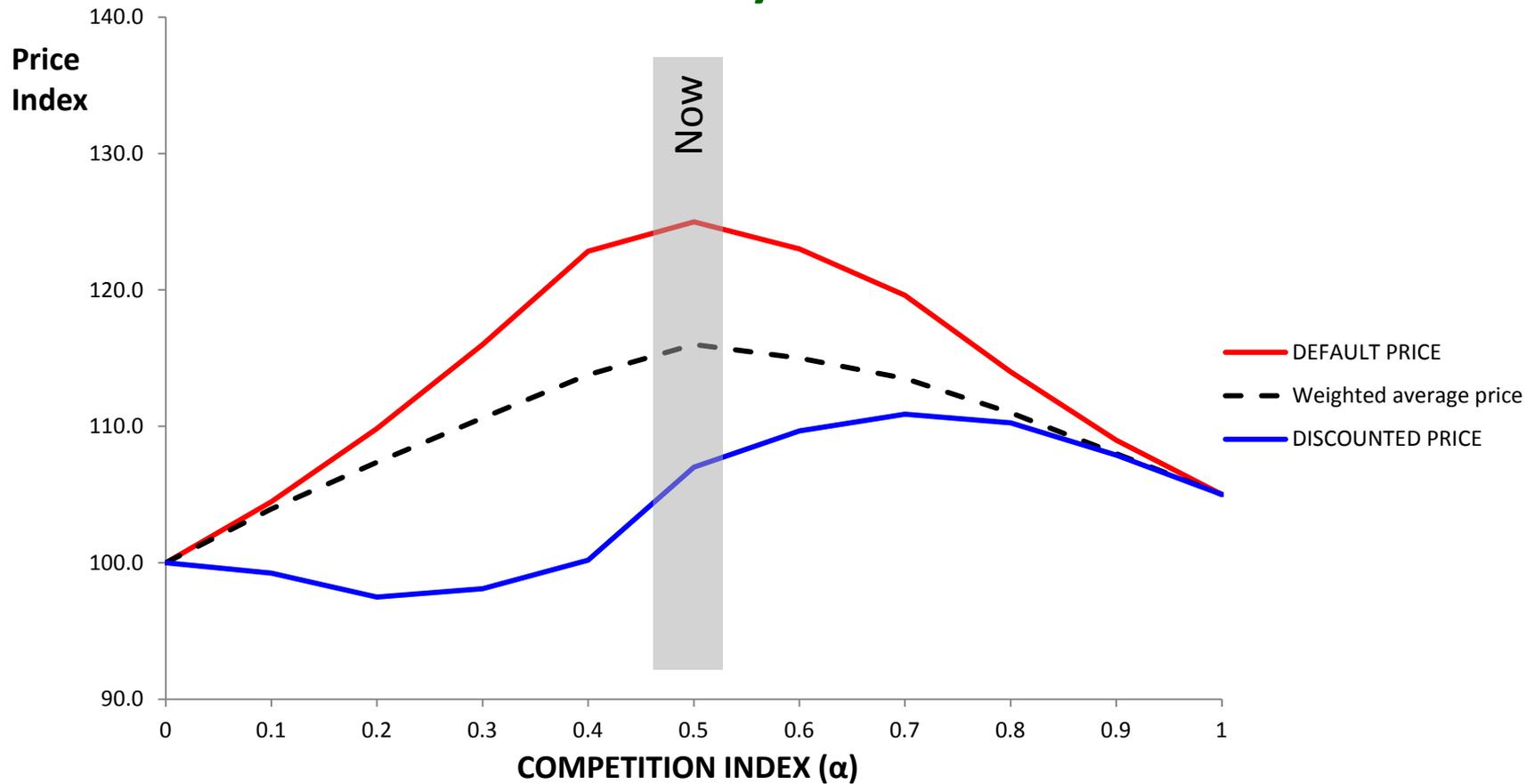
Regulatory responses should be assessed according to:

- (i) their ability to reduce competition costs
- (ii) their ability to reduce the extent to which competition costs are passed through to customers

or both.

Some regulatory risk-taking is acceptable and necessary. It may be the only way to discover the merits and limits of regulatory interventions in the retail energy market.

# The necessary future





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