

Market Monitoring in the Electricity & Gas Retail Markets

Submission by the Competition Authority to the Commission for Energy Regulation

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The Competition Authority
An tÚdarás Iomaíochta

Introduction

- 1.1 Market monitoring is an essential feature of all electricity regulation regimes given the susceptibility of electricity markets to market power.
- 1.2 EGREG's template for retail market monitoring as set out in page 22 of the consultation document represents a sensible approach to market monitoring. In a deregulated market environment, market monitoring should focus on consumer satisfaction in terms of value and choice rather than static measures of concentration as a means of assessing how competition is working for consumers
- 1.3 Therefore any definition of competition in retail electricity should reflect the idea that competition is a dynamic market process encompassing a number of features other than price and market share. In addition to price, the criteria for assessing competition in electricity should be expanded to include the delivery of additional services such as energy saving advice and more demand-responsive tariffs that meet customers' preferences.
- 1.4 The CER already receives a substantial amount of data from network operators and retail market participants and publishes regular market updates. This consultation is largely concerned with the expansion of those reporting requirements to give a more accurate picture of how competition is evolving and whether competition it is working for consumers.
- 1.5 This submission concentrates on the competition aspects of the new data the CER is requiring to fulfil its statutory role in monitoring the Irish retail energy market. An important consideration in this process might be the cost of complying with the additional requirements relative to the benefits. A cost which will ultimately passed on to consumers.

Measures of market concentration and competition

- 1.6 Measures such as the HHI are useful as indicators of concentration but are considered as only initial screening devices in any competition assessment. These indicators measure the actual market shares without making any inference about the strategic behaviour of market participants. Other industry characteristics such as the threat of entry, the presence of powerful upstream generators, the degree of vertical integration and the presence of concentrated Large Energy Users may affect the extent to which retail suppliers are able to exercise any market power. The analysis of market structure alone is an unreliable means of identifying a causal relationship between high market share and anti-competitive conduct.
- 1.7 Given the limitations of purely structural indicators, a better approach is to measure the degree of competition with respect to the actual behaviour of retail suppliers and the other features of the market that may augment or mitigate market power. Competition analysis is related not only to market structure, but also to the existence of entry barriers, switching rates, tariff design and proliferation and additional services that retail suppliers provide.

Proposals for reporting of retail margins

- 1.8 In general, there is a concern that the costs involved in compliance with any requirements regarding the reporting of retail profit margins may outweigh any benefits that this data would contribute to a competition analysis.
- 1.9 In theory, the margins that retailers earn can provide insight into whether a market is subject to effective competition, as one outcome of effective competition is pressure for prices to converge to become more cost reflective over time. However, in the short run, retail margins in electricity supply are likely to diverge for a number of reasons.
- 1.10 Firstly, as wholesale energy costs can be volatile, suppliers try to smooth retail prices knowing that customers value both low and stable prices. Suppliers employ different hedging strategies involving forward and spot contracts of varying maturity to manage this market risk, the details of which are commercially sensitive.
- 1.11 Secondly, it is difficult to draw any inference from retail margins in any specific period given that firms choose various methods of allocating costs across different business units and product lines. Attributing profits to a specific business unit held within a wider group is likely to be complicated by the difficulties associated with the allocation of joint and common costs and assets. Furthermore the assets themselves might be difficult to identify and value on the basis of intangibles such as goodwill and brand value, risk management and trading activities.
- 1.12 Overall, this suggests that while profitability analysis may act as a useful complement to other competition indicators it may be challenging to apply in the case of the retail electricity sector.
- 1.13 In addition, high profit margins may be the result of efficient operations or outperformance and it would be antithetical to the competitive process if a supplier was punished in some way for superior performance. Alternatively, low reported margins might be used as a means of deterring entry. Given that the accurate measurement of retail margins is so difficult, any requirement on profit margins may not be particularly informative.
- 1.14 The difficulty that is involved in attempting to estimate efficient cost and the efficient price level is one of the reasons for preferring competition over tariff regulation. If all retail suppliers had the same costs and margins as each other there would be no incentive to switch. In competitive markets, efficient cost and prices are revealed over time by the competitive process of offer and counter offer and entry and exit from the market.

Proposals for monitoring the diversity of tariffs

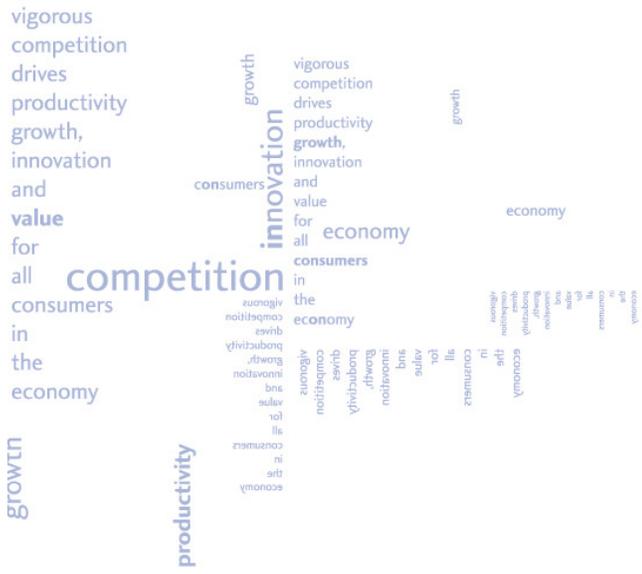
- 1.15 The objective of monitoring tariffs, both in terms of their level and diversity, is to identify and publish trends with a view to providing a timely indication of any possible future deterioration in the effectiveness of retail competition and in the competitiveness of observed prices.
- 1.16 Since tariff regulation was removed from ESB Customer Supply (now Electric Ireland) in 2011, electricity suppliers have been governed by general competition law which constrains price discrimination by dominant suppliers only. Tariff proliferation is a common way for electricity suppliers to price discriminate and attract new customers. Competitive markets require that at least some consumers make an effort to search for better value and to avoid bad deals.
- 1.17 This searching activity by active consumers helps less active consumers become aware of the value on offer and so has a positive effect on overall consumer welfare. The more that consumers know about deals in the market, the greater is the competitive pressure on firms to offer good deals.
- 1.18 While there are legitimate concerns that excessive tariff proliferation can lead to confusion among some customer groups, the CER should not take any interventions which would discourage active consumers from seeking better deals. It may well be the case that there are groups of consumers that are not availing of the lower electricity prices currently on offer. But a clear distinction should be drawn between those who prefer not to switch from their current supplier from those who are constrained in some way from switching and are therefore at risk of exploitation. If some currently inert consumers are susceptible to behavioural biases as suggested by research in the field of behavioural economics, then these biases can be addressed by, for example, presenting price comparison information in a form that is clear and easily accessible.
- 1.19 Market power in retail electricity can be reduced through policies to increase the elasticity or responsiveness of consumers to changes in price. There are a range of demand side measures such as price comparison websites and smart metering which enhance the ability of consumers to respond to changing market offers.

Proposals for monitoring end user prices

- 1.20 Customers vary widely in the quantity of electricity that they consume and the costs of providing them with customer services. Accordingly, metrics of retail electricity prices and costs that focus on averages across consumer segments can be misleading.
- 1.21 Retail electricity costs comprise both a fixed element relating to the cost of business operations and a substantial variable element relating to the wholesale price of electricity which in turn is largely determined by world energy prices.
- 1.22 Retail electricity suppliers offer prices that are fixed for a period of time, based upon their forecasts about future energy prices. Thus, even if the retail prices that retailers offer included an expected profit margin over the forecast cost of serving that customer, the actual retail

margin – which will reflect the spot price of energy will inevitably differ to the intended margin as a result of the difference between forecast and actual energy costs.

- 1.23 There is therefore a need to treat with caution, in the short term at least, any estimates of retail margins and prices and inferences drawn from them about the effectiveness of competition given the imprecise nature of retail margins and advertised prices.



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