Competition Authority Submission

CER Consultation on Market Monitoring in the Electricity & Gas Retail Markets (CER/13/302)

February 2014

S-14-003

The Competition Authority
An tÚdarás Iomaíochta

COMPETITION AUTHORITY COMMENTS ON PROPOSALS FOR REPORTING OF RETAIL MARGINS

Introduction

1.1 The Competition Authority welcomes the opportunity to make this submission as market monitoring is an essential feature of all electricity regulation regimes given the susceptibility of electricity markets to market power. Furthermore, we accept that market monitoring will become an increasingly important aspect of regulation as the retail energy market moves towards full liberalisation.

1.2 The Authority made a comprehensive submission (S-12-001) to the previous public consultation on retail market monitoring in which we stated that 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]

1.3 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 quality and choice.

1.4 While the CER's consultation document covers a wide range of consumer-related issues which must be taken into account in the establishment of the new market monitoring framework, the Competition Authority's submission will focus solely on the issues which directly affect competition between energy suppliers.

1.5 The CER's approach to the collection of structural indicators of competition is not controversial and has been supported in our previous submissions, however in this current submission, the Competition Authority would like to reiterate its concerns first expressed in its submission to consultation CER 11/221 regarding the CER's proposal to publish energy suppliers' retail margins at aggregate level. While it is accepted that the CER does not intend to assess margins in isolation but in conjunction with other complementary indicators, the publication of margins is not necessary in a competitive market and could lead to less competition.

1.6 Firstly there is a general 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. It would be extremely difficult to use the data on retail margins for any practical policy purposes, for instance to choose the "right" level of competition. Retail margins can vary depending on firms' cost assumptions and accounting methods and are therefore susceptible to manipulation. Furthermore, publishing retail margins in a competitive market could provide a focal point for price coordination between suppliers, which is antithetical to competition.

[1] Available to download from our website at: http://www.tca.ie/EN/Promoting-Competition/Submissions/Monitoring-the-Retail-Electricity-Market-.aspx

Margins in Theory and in Practice

1.7 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 energy supply are likely to diverge for a number of reasons.

1.8 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.

1.9 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 products. 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.

1.10 Thirdly, energy suppliers are constantly searching for new ways to price and pay for energy that they think will be valued by customers. In doing so, suppliers may be willing to sacrifice margins in the short term to introduce new services. Some of the products in the market today will survive while others will fall by the wayside. For example, online billing reduces suppliers' costs, so they can offer discounts to customers who are prepared to receive bills online and pay by direct debit. Similarly, some customers are willing to pay higher prices for green energy. In a dynamic, competitive environment, higher margins generated by successful products offset the losses on unsuccessful rollouts.

1.11 Competition is ultimately a discovery process, where suppliers are continuously trying to find and provide what customers want. Offering different products or terms to different customer segments makes it possible and profitable for suppliers to compete in a way that would not be possible, or not profitable, if they were required to publish their margins on these products and disclose their strategies to their competitors.

1.12 If a firm's costs fall over time due to improved efficiency, its profit margin will rise. Such an increase in profit margins should not be interpreted as a lessening of competition. Efficiency and innovation should be rewarded in a competitive market. Otherwise, sanctioning a firm for being too efficient or innovative sends a negative signal to the rest of the market which would discourage investment and leave consumers worse off.

1.13 Overall, for the reasons outlined retail margin indicators would be challenging to apply in any analysis of the retail electricity sector and the purpose of collecting this data is unclear. Furthermore, the publication of margins could be counterproductive to the core objective of developing a more competitive market.

1.14 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 to publish profit margins may not be particularly informative.

1.15 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.

1.16 There is no single price-cost margin that suggests normal or competitive behaviour, just as there is no single price-cost margin beyond which market power may be inferred.

The Threat of Collusion

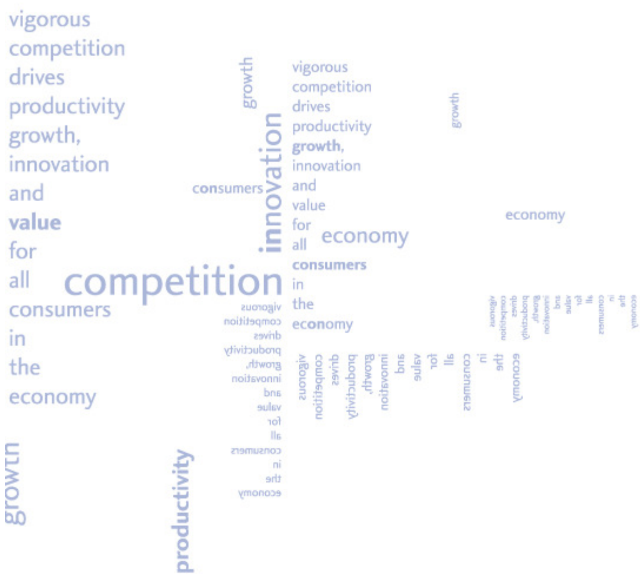
1.17 Collusion between competing firms is generally illegal under competition law. However, the legal position is less clear if it can be demonstrated that these firms are acting in response to a regulatory requirement or request. Regulatory involvement that might require or lead to coordinated effects should be avoided.

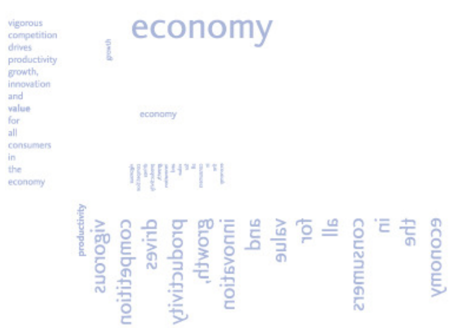
1.18 Consumers are already aware of the prices charged by energy suppliers through their advertising and through cost comparison websites. There is no lack of transparency with regards to consumer end prices. The publication of retail margins would only serve to increase the transparency among rival firms with regard to each other's profitability. This would only be of benefit to firms who wish to raise their prices to the industry standard without fear of sanction from regulatory authorities.

Conclusion

1.19 Wide variations in margins are typical in competitive markets where suppliers employ a variety of strategies to attract customers. The publication of retail margins by the CER could inhibit product innovation and therefore reduce competition as suppliers will be reluctant to innovate out of fear that they may be punished if margins are too high. The publication of retail margins could also have further detrimental effects on competition if the published margins become the focal point for collusion between supposed rivals.

1.20 Consumers should be concerned about getting the best value offers and the CER's efforts should be concentrated on helping consumers to make the better purchasing decisions and facilitating switching between suppliers. But there is a danger that the publication of retail margins in a competitive market will reduce, not increase, competition, and all customers will be worse off.





The Competition Authority, Parnell House, 14, Parnell Square, Dublin 1, Ireland
Tel: +353 (0)1 8045400 LoCall 1890 220224 e-mail: info@tca.ie

www.tca.ie