
Social Objectives and the Market

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Social Objectives and the Market: A Case study

1. Ofgem's actions and the questions it raises for the market and social objectives
2. Background findings from the Probe
3. Undue discrimination clauses: Likely effect on competition
4. Effects on vulnerable consumers
5. Competitive markets and social objectives

1. Ofgem's Action: April 09

“We remain convinced that consumers benefit most from a vibrant, competitive market: markets work best when consumers make active choices based on good quality information. We are therefore proposing a package of measures designed to improve the functioning of the market for all consumers, particularly vulnerable households. Over time, we expect these remedies - through the operation of the market - to address instances of undue discrimination.

Ofgem, Addressing undue discrimination - final proposals April 2009

Ofgem's Action: April 09



“In the meantime, competitive pressures alone may not be sufficient to protect consumers from undue discrimination and this may disproportionately harm vulnerable consumers.....

“We are introducing [non discrimination clauses] to address other situations in which certain consumers may be losing out by reason of their inability to access (or difficulty in accessing) the same supply terms and conditions as other consumers.....

Ofgem's Action and questions for the market

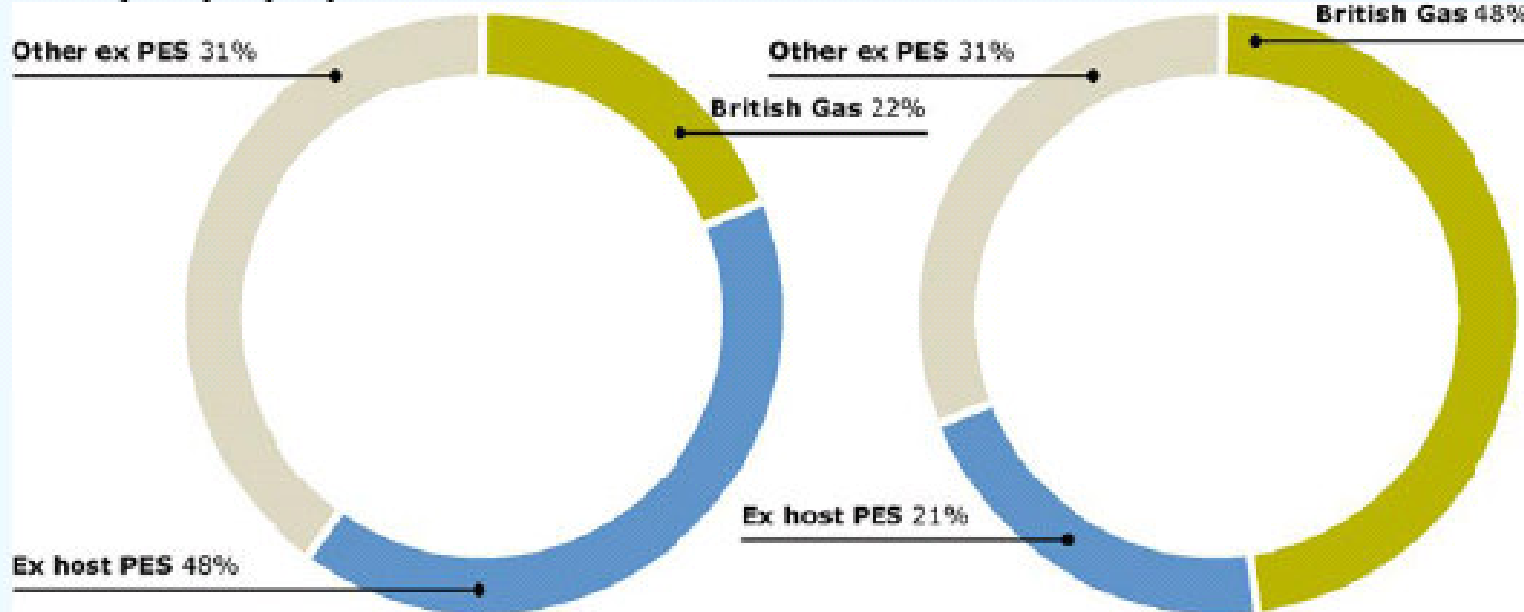
“The inclusion of a sunset clause provision ... is intended to reflect Ofgem’s expectation that the full package of measures proposed in the “Energy Supply Probe - proposed retail market remedies” document published in April 2009, will accelerate the transition of energy supply markets to fully effective competition and that, over time, those measures alone will be sufficient to guard against undue discrimination”. Ofgem April 09

- ✦ Can non-discrimination clauses deliver both effective competition and protection for vulnerable consumers?
- ✦ Are there more general lessons for competitive markets and social objectives?

2. Background findings from the probe

In each region, the former local electricity incumbent and the national gas incumbent dominate...

Figure 3.4: Current average regional supply market shares electricity (left) and gas (right)

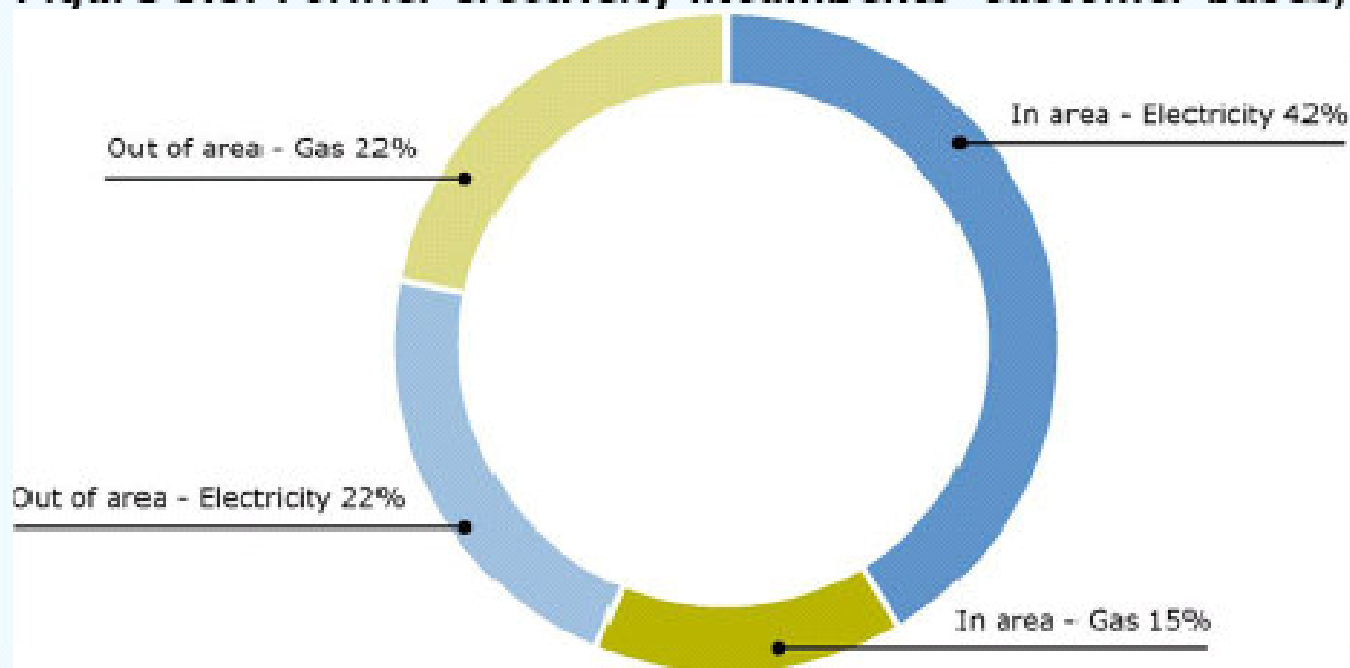


Source: Ofgem

Note: Electricity shares are for June 2008; Gas shares are for December 2007.

...and each electricity supplier's customer base is strongest 'in area'

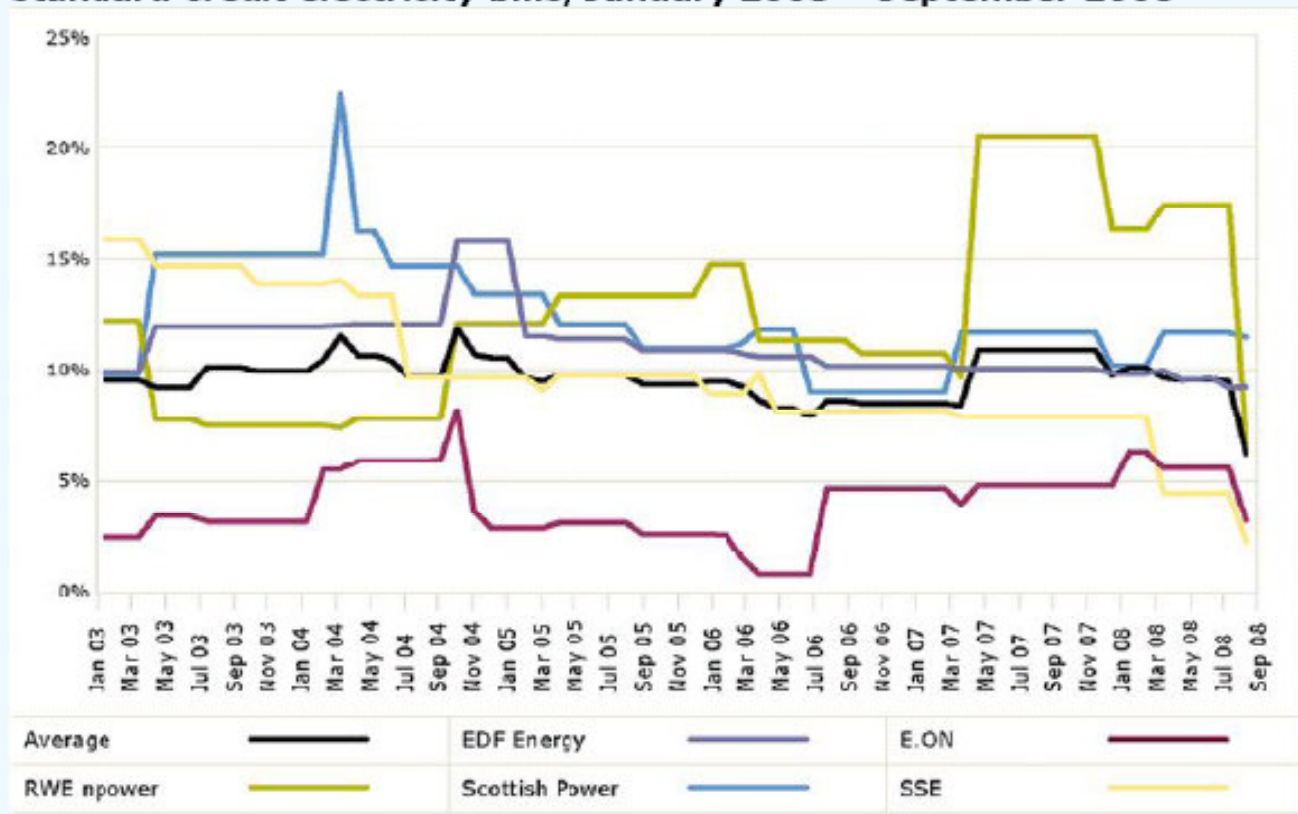
Figure 3.8: Former electricity incumbents' customer bases, December 2007



Source: Ofgem

...and incumbents charge higher prices, average 10-12% 2003-Jan 08

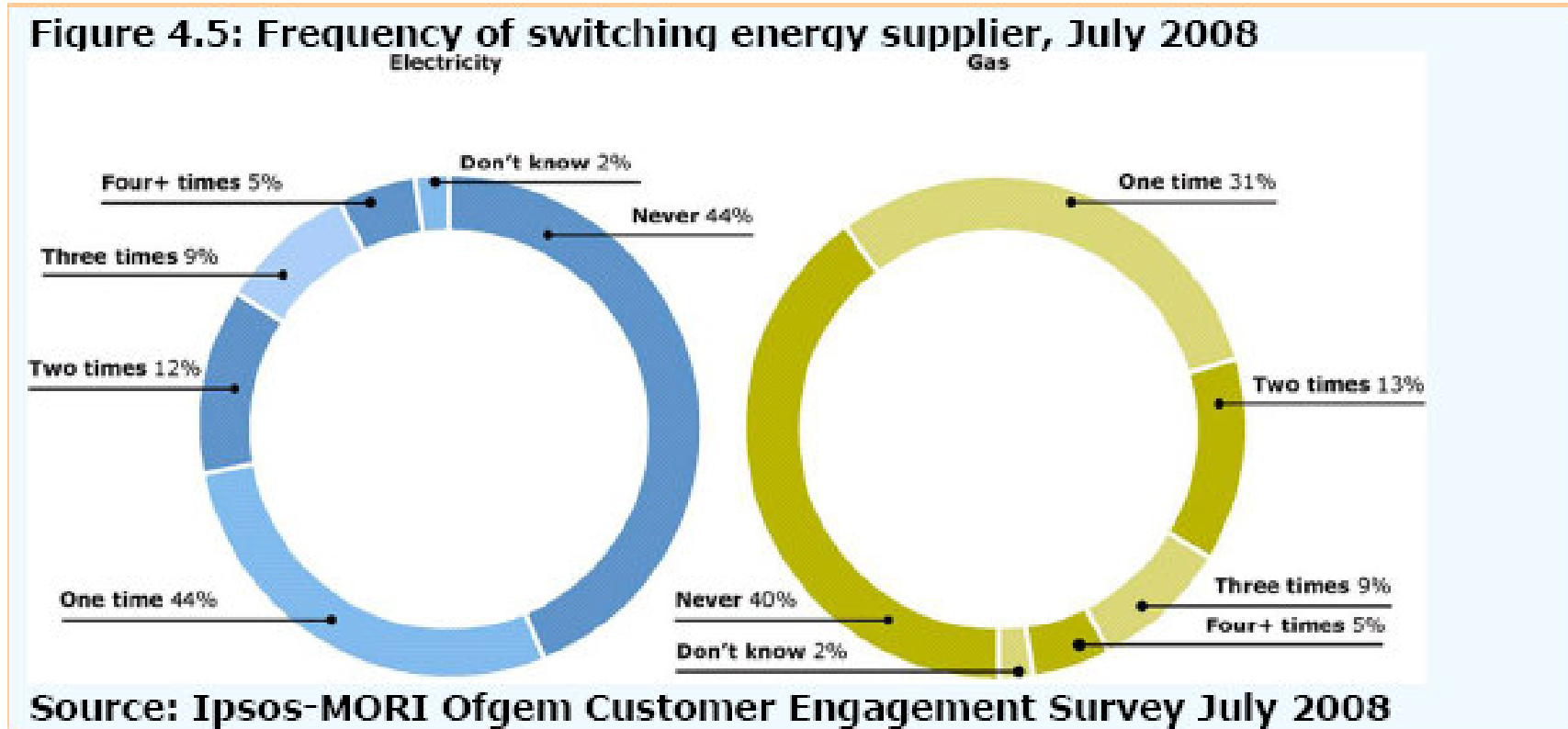
Figure 7.4: Average percentage difference between in-area and out-of-area standard credit electricity bills, January 2003 – September 2008



Source: Ofgem

So there are significant potential gains from switching...

...but despite potential gains from switching, incumbents retain loyal consumer base

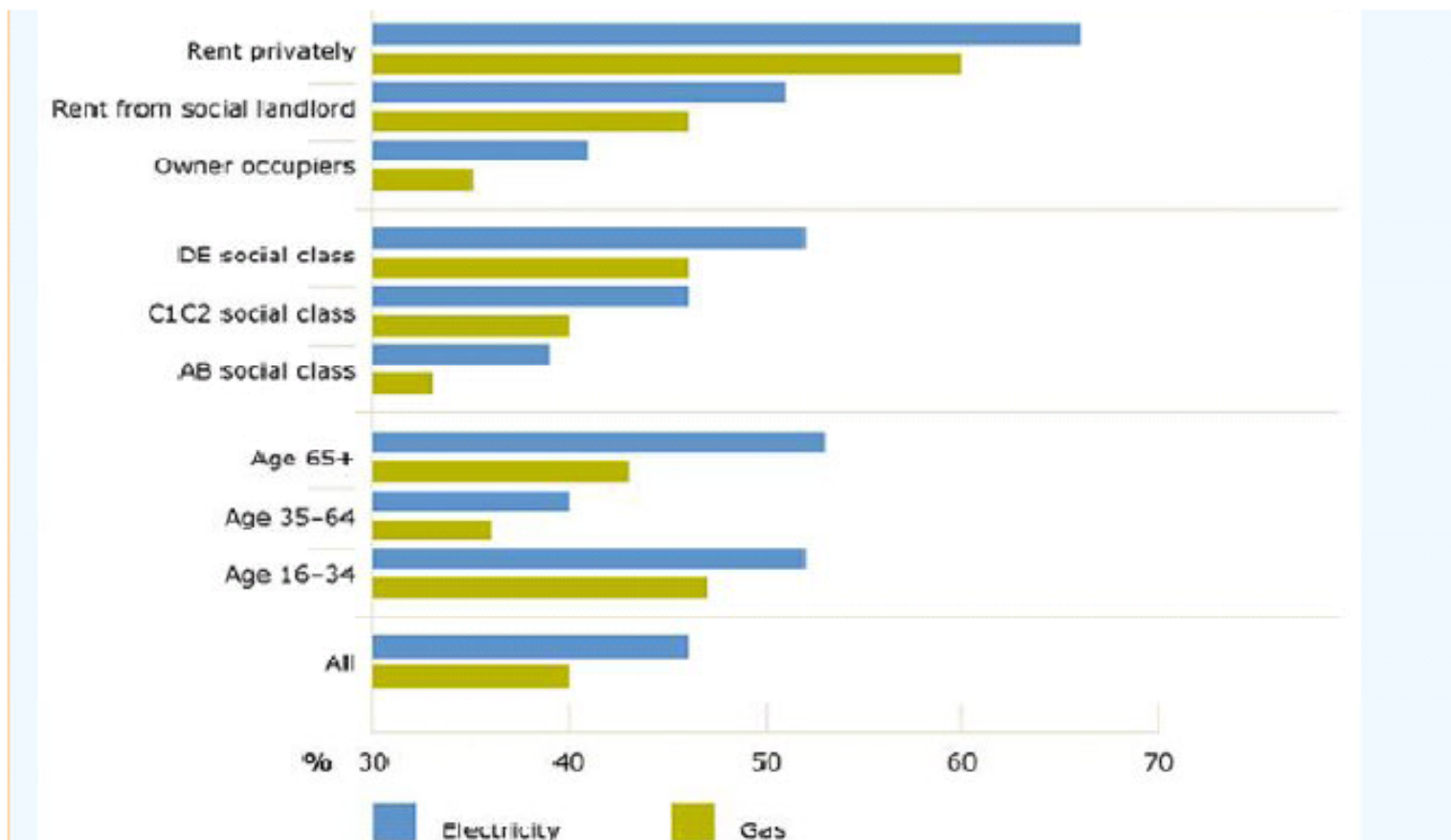


44% have never switched electricity supplier

Who are they?

Concern that non switchers disproportionately 'vulnerable'

Consumers who have never switched energy supplier



Source: Ipsos MORI Ofgem Consumer Engagement Survey, July 2008

3. Non discrimination clauses

- ✦ More vulnerable customers amongst non switchers
 - ✦ Strong consumer lobby that this is unfair, particularly as prices rose in 2008 (for other reasons)
 - ✦ Introduced ‘no undue discrimination’ clause in licenses from September 2009
 - ✦ Prevents companies charging more (relative to costs) in their home region, i.e. can no longer charge lower margins out of region

4. Consequences of clauses (ND) for competition

- ✦ Traditional view: rebalancing will lower ‘in area’ and raise ‘out of area’ prices as regulator intends
- ✦ But Bester and Petrakis show that the effect on competition depends on ‘strong’ and ‘weak’ markets, i.e. whether consumers are sensitive to price changes:
 - (i) if one firm’s ‘strong’ market (low price responsiveness) is another’s ‘weak’ (high responsiveness) market, ND is anti-competitive, prices rise
 - (ii) if firms view markets similarly, prices fall in low elasticity market, rise in high elasticity market, like the traditional view above

Consequences of clauses (ND) for competition and consumers: 2



For electricity firms, one firm's strong market (where it has been incumbent) is another's weak market (where it is entrant), so non discrimination enables them to divide the markets and moderate competition against each other

But in each region (most) electricity incumbents also face another incumbent - British Gas - who may view all markets as strong since it is incumbent nationally

Pull in opposite directions

Modelling which effect dominates

If firms are free to set their own prices

Traditional situation: two regions with two electricity firms facing the same costs (one entrant and one incumbent in each region); and a third company, G, active in both regions. All 3 firms are active, and each incumbent sets lower prices out of their area than 'in area'; global incumbent G sets same price everywhere

If firms are required not to discriminate, then the prices for each electricity firms as incumbent and entrant must become the same

When price discrimination is prohibited

- ✦ If incumbency advantage is strong enough, entrants cease to exert competitive pressure and both regional electricity and national (gas) incumbent raise their prices
- ✦ At lower levels of incumbency advantage, the regional incumbent lowers price, and the entrant and national incumbent raise theirs
- ✦ Average prices and profits are higher in **both** cases

So why haven't firms done this themselves?

- ✦ Complications of different costs in different regions; same results but more difficult to monitor
- ✦ National presence of British Gas
- ✦ Suppliers genuinely committed to competitive market (potential damage to competition cited in responses to consultations)
- ✦ Concern that regulator would intervene

Two counterarguments to damaging effect of ND clauses



Entry

Higher profits should attract entry from other firms
(but there is evidence of barriers to entry)

Ofgem pursuing other means to reduce this

Market not previously competitive so comparison invalid

Arguments about co-ordinated effects

If so, ND clauses make for easier co-ordination, but may be moving away from a 'less good' situation

4. Do the vulnerable benefit? % with each type of supplier (2005)

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*
<i>All consumers</i>	<i>42</i>	<i>32</i>	<i>26</i>

*Signif'tly
different
from non
vulnerable
at 1%

Immediately: Yes, more with incumbent than with entrant;
but British Gas will increase price, so more will lose than gain
and if entrant competes less strongly all prices will rise

5. Competitive markets and social objectives

- ✦ Ofgem's actions reveal very strong preference for immediate 'fairness' for vulnerable at expense of longer term competition and lower prices
- ✦ Ofgem introducing many good initiatives to help consumers, especially vulnerable, make better choices - just as the incentives/benefits to do so may disappear
- ✦ Confusion between (possible) outcome of competition (equal prices) for process

What can competition deliver?

- ✦ Choice for consumers, and good price signals on relative costs, including environmental costs if they are included
- ✦ Incentives for efficient operation and innovation (and so lower prices for consumers)

And what can't it deliver?

- ✦ Equality either of opportunity or of outcome

Social objectives

- ✦ Can be delivered outside the market: incomes, opportunities
 - ✦ Or by the way the market is set up, e.g. subsidies for particular households (but beware unintended consequences)
 - ✦ Or through monopoly networks
 - ✦ Or (somewhat) by regulated prices
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- ✦ Energy Bill: government recognises that it should take responsibility for achieving non market objectives

Is competition the best market mechanism for domestic consumers?

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- ✦ Concern that government still see delivery of social support as through the market via supply companies, which may hamper competition
 - ✦ And that short term measures to address discrimination may damage long term competition prospects
 - ✦ Competition is a powerful tool, but cannot deliver equity in the household market (or elsewhere).
- Can it deliver sustainability and security?
- ✦ Using inappropriate tools is likely to result in the worst of all possible worlds