

Introducing Competition and Deregulating the British Domestic Energy Markets: A Legal and Economic Discussion

December 2006

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CCP Policy Briefings

INTRODUCTION

- Competition law and policy is concerned with the identification of competitive constraints which prevent a firm or group of firms from exploiting single or joint dominance in a market, and to develop potential remedies when such constraints are absent or ineffective.
- This paper focuses on the British residential energy markets; here, the introduction of competition is justified if it reduces costs and prices below the level which regulated monopoly can achieve, or engenders innovation among firms to the benefit of consumers.

BACKGROUND

- British energy markets were opened to competition between 1996 and 1999.
- To protect consumers from potential abuse of monopoly power, retail energy markets were subject to *ex ante* price controls (contained in the firms' licenses) which the regulator gradually removed until full deregulation in 2002.
- Following the removal of *ex ante* controls, the regulator (Ofgem) relies solely on the *ex post* provisions of the Competition Act 1998 to regulate pricing practices.
- The Utilities Act 2000 created new duties for the regulator (Ofgem), such as taking account of the needs of low income consumers. The Act also created a consumer watchdog - energywatch - whose responsibilities are providing market information to consumers and representing and championing their interests.

CONSUMER SWITCHING AND MARKET POWER

- **Switching Behaviour:** Switching costs are disadvantages which a consumer perceives would be incurred by changing to another supplier but not by staying with the current one. Costs may be financial (e.g. losing out on loyalty rewards), involve time (in searching or switching), or be psychological (e.g. concern about a new supplier).
- Search costs were found to be a barrier for many, and switching costs were perceived to be high (relative to the reality) in terms of time. Pensioners and prepayment consumers were less likely to be aware of the possibility of switching and those in rural areas less likely to make the change.
- **Pricing Behaviour:** Antitrust issues in residential energy supply centre around two concerns: single and joint firm dominance.
- Consolidation, mainly by takeover, has led to the domination of both the national gas and regional electricity markets by six main players - the gas incumbent and five descendants of the regional electricity incumbents. The incumbent in each market has therefore retained considerable market share (upon privatisation, incumbents inherited 100% of their respective markets; most retain around 50%) and is able to charge a significant price premium over entrants.
- The first competition concern is that the incumbent may remain dominant because consumers do not exact a sufficient competitive constraint through their willingness to change suppliers. Both empirical evidence and the experience suggest that there was and still is cause for concern.
- Consumers who are reluctant to switch may contribute to the *sustainability* of coordinated effects, the three key conditions of which are:
 - High market concentration;
 - Ability to respond quickly to price changes;
 - Weak competitive constraints.

Other contributory factors are that energy is an homogeneous product; that there is repeated interaction between energy supply companies; that there is a regulatory requirement for publishing tariff information (increasing price transparency); and that prices can be changed quickly.

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TRANSITION FROM MONOPOLY TO COMPETITION

- **The Rebalancing of Price Controls:** Before competition was introduced, the incumbent was subject to a price cap on the average revenue raised but not on individual tariffs; this allowed them to rebalance tariffs. The regulator devised a new method from April 1997 to March 2000 with price controls on each tariff category to prevent undue price discrimination between tariffs. Controls on direct debit tariffs were removed in April 2000; the regulator deemed that controls needed to remain on the credit and prepayment tariffs until April 2002 to protect consumers (in particular prepayment customers).
- **Establishing Competition:** The rebalancing raised some concerns: the reduction of the potential profitability of new entry in direct debit markets; and higher prices imposed on those consumers who were in the less profitable sub-markets.

THE EX-POST POLICING OF PRICING PRACTICE

- The regulator's guidelines, first published in 2001, noted that it may take some considerable time for sector-specific case law to develop. Ofgem has consistently committed itself to being vigilant of pre-emptive behaviour on the part of incumbents.
- Such behaviour may consist in price discrimination between customers who have switched and those who have not.
- Certainty over what is a legitimate response to competition on price by a dominant firm is a matter that is currently vexing the EC Commission and the antitrust community.
- It may be that the costs of intervention, in particular the potential dampening of vigorous price competition, are too high to warrant an intervention. However, uncertainty itself may have a similar effect, encouraging six closely related firms to soften competition between one other in a number of closely related markets.

CONCLUSIONS

- Deregulation is only partial in the sense that the industries retain sectoral regulatory institutions (a regulator and a statutory consumer watchdog).
- The experiment to deregulate British residential energy markets was a bold one and it seems the outcome is not yet clear.
- Deregulation of pricing was seen as necessary to implement the experiment fully, and if the regulator's optimism is correct, we could see lower prices, more innovation on the part of suppliers and more choice for consumers as a result.
- If the worrying signs of dominance and high incumbent prices continue, however, there are real concerns about the effect on consumers who are reluctant to switch providers, and particularly low income and other vulnerable households.
- The outcome of this experiment, and the role of the regulatory institutions, will provide important lessons for other countries contemplating opening their own residential markets to competition in the coming years.

THE CCP

The ESRC Centre for Competition Policy (CCP), at the University of East Anglia, undertakes competition policy research, incorporating economic, legal, management and political science perspectives, that has real-world policy relevance without compromising academic rigour.

FOR MORE INFORMATION

The full working paper (CCP Working Paper 06-20) and more information about CCP and its research is available from our website: www.ccp.uea.ac.uk

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