Oxera

Agenda

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Competition in energy markets: a consumer perspective

The March 2008 issue of *Agenda* assessed some of the competition concerns relating to energy retailing in light of the regulator's market probe. In a challenging response to this article, Allan Asher, Chief Executive of energywatch, the independent watchdog representing gas and electricity consumers in Great Britain, suggests that competition in energy markets may not be effective in practice

Oxera's *Agenda* article, 'Energy supply markets: are they competitive?' (March 2008) addresses four themes that a competition review of the electricity and gas sectors should consider—market structure, conduct, barriers to entry, and performance—and outlines some possible remedies. The article makes a number of arguments that, in the round, imply that competition in these markets may be working rather better than may actually be the case. Indeed, a number of stakeholders, such as energywatch, believe that a full and independent market investigation needs to be undertaken by the Competition Commission to ensure that energy markets deliver much better benefits for hard-pressed consumers. In my opinion, although the arguments in the March 2008 article are well presented at a high level, they represent a theoretical best case rather than the real-life situation, which is much worse.

Competitive energy markets are of course very topical at the moment because of the separate inquiries being run by the House of Commons Business and Enterprise Select Committee and Ofgem, the industry regulator. But it is important to remember the reasons for this activity. These include the very real pain being caused to consumers by the high cost of energy: there are 4.5m households in fuel poverty, needing to spend 10% or more of disposable income on energy bills. There has been a 64% rise in three years in consumers owing more than £600 on their electricity bills, and a 19% rise in consumers owing more than £600 on their gas bills.[1]

In this response I will review the main arguments tabled by Oxera and compare them with information and data on the electricity and gas markets that consumers are actually experiencing. energywatch has recently submitted to the Select Committee a position paper that sets out our views much more fully, including a review of recent independent statistics and analysis.[2]

Data on market structure says that there is a problem ...

energywatch considers that, overall, the *Agenda* article presents the energy markets as being in a much better state than they actually are. Its take on market structure is typical of this emphasis: the article states that market share analysis 'may not take account of other features of the market that may augment or mitigate market power'. This is attributed to the following factors: purchaser power, the threat of new entry, or powerful upstream producers that may limit the extent to which dominant firms may be able to exercise their market power. These factors may indeed exert some mitigating effect at a theoretical level, but in the real world of British electricity and gas they do not. Householders buy energy individually and therefore exercise no buyer power at all. Indeed there are very strong arguments from academics that confusion is disempowering consumers, with many yet to switch at all, and many of those who have done so—particularly those on low incomes—making the wrong choices.[3]

Neither is there the realistic threat of new entry upstream or downstream. Since 2000, some 25GW of generating capacity, around one-third of all major UK plant, has been transferred from independents to the Big Six—British Gas (Centrica), EDF, npower (RWE), Powergen (E.ON), Scottish & Southern Energy and Scottish Power. Twenty suppliers have left the electricity market over the same period. Those independents still in the household market serve a very small niche of consumers—less than 1%, according to recent statistics from Ofgem.[4]

The same qualifications are apparent with regard to the suggestion that vertical integration may not be a sign of barriers to entry, but 'may be welfare-enhancing to the extent that it reduces transaction costs, passes on synergy benefits … to customers'. Also, according to the article, it might better facilitate large investments and overcome 'external costs arising from illiquid or incomplete markets' such as security of supply. Again, these propositions may have some merit in economic text books, but in practice all the evidence points the other way. energywatch believes that integration and declining wholesale market liquidity are directly linked to consolidation and are mutually reinforcing. Lower volumes available for wholesale trading reduce the ability of independent players to bring competitive pressures to bear on the Big Six. Again this view is based on observation and analysis, and not just opinion. The European Commission's 2006 sector inquiry report found the UK to be the only major European power market where wholesale volumes were falling.[5] More recent figures from RWE suggest that this trend is continuing.[6]

Furthermore, Oxera suggested that international factors, as well as British market issues, may explain why consumer prices had risen. Indeed the article strongly implies that the former has made the most important contribution. Again there is independent data here to the contrary. Cornwall Energy recently estimated that power bills to householders in Britain rose between 2003 and 2006 by more than £2 billion more than the industry's costs, with the benefit of increased costs transferring mostly to power generators.[7] Back in 2005, IPA Energy reported to the UK Department of Trade and Industry (now the Department of Business, Enterprise and Regulatory, Reform, BERR) that the combination of free EU carbon allocations with full pass-through of marginal costs would transfer £800m every year from power consumers to producers for each of the first three years of the EU Emissions Trading Scheme.[8] If the power market were functioning properly, these potential windfalls would have been competed away, and Ofgem would not have resurrected its proposal for a tax on the £9 billion windfall that generators are going to earn in the Scheme's second phase to 2012—£1.8 billion in each of its five years, Ofgem estimates.[9]

The article also suggests that the reduction in the number of suppliers to the Big Six, given the continuing existence a competitive fringe, 'may not represent a marked increase in concentration, let alone a significant reduction in competition', especially if the supply market is now national. But the market is not national: the latest figures from Ofgem show that, in March 2007, in six of the 14 electricity supply regions in Britain the home supplier still held more than half the market, and in some cases considerably more.[10] BERR data also shows that, in four of the 12 gas regions, British Gas retained more than half of the customers at this time.[11]

Data on conduct also says that there is a problem …

It is difficult, as Oxera states, to establish a clear relationship between retail and wholesale prices. energywatch also agrees with the statement that a 'simple comparison of spot wholesale and contemporaneous retail prices may not be particularly informative'. But again the article does not reflect a key point. The Big Six continue to imply that they are fully or significantly exposed to the year-ahead wholesale gas and power markets, despite minimal trading volumes and the existence of extensive legacy fuel supply arrangements, like the long-term interruptible gas and UK coal contracts. energywatch is very suspicious that prices to customers, especially for electricity, are poorly related to the company's costs of production. Unfortunately, financial reporting by the Big Six is insufficiently transparent to make definitive judgments on these matters, and we believe this lack of disclosure of trading between affiliates and of transfer prices represents a major regulatory failing that needs to be addressed—and one that the article could usefully have highlighted. Declining wholesale liquidity has had a negative impact on both price discovery and the ability of competitors to the Big Six, as two of their number recently told the *Financial Times*.[12]

… so we should look at it

Oxera's contention that not all entry barriers are necessarily erected by incumbents is probably true. But it is another point entirely to suggest that vertical integration may be providing a net benefit to consumers.

Likewise, the conclusion that, when considering the performance of the market, it may just be too difficult to measure accurately whether prepayment users really are paying more than they should be for their energy ought not to be used as an excuse not to take a look. The information is available on grid charges, taxes and cost to serve, and energywatch regularly publishes delivered costs to consumers for the main terms of supply.[13] Moreover, this information shows that this year the GB average online direct debit price has risen just 5%, whereas the GB average prepayment meter price has risen 10%, indicating that the relative situation of many vulnerable consumers is deteriorating.[14] It is not clear that the costs of serving prepayment users have risen to justify this change, or even that the wider price differential between different payment terms for an identical energy supply can be justified in cost terms.

We are also concerned that remarks to the effect that profitability analysis may only evidence operational inefficiency rather than profiteering could deter the undertaking of this important analysis.

After suggesting that they are not necessary, the article presents potential remedies. But these are presented in such a way that the lay reader would probably not be persuaded of any of their effectiveness. And seemingly to reinforce this implication, the article concludes by reviving the argument that we often hear from the Big Six about vague threats to investment and security of supply.

Such an ending represents a particularly disappointing conclusion to an article whose purpose may have been to advance general arguments, and shows that the authors bring no preconceptions of their own to the current situation. What actually emerges, in energywatch's opinion, is an article that, through its advancing of arguments without considering available data, could give a misleading impression about the effectiveness of current market arrangements for electricity and gas supply in Great Britain.

Allan Asher

[1] energywatch (2008), 'Switching Rates Up but Consumers Still Losing Out, Says energywatch', press release, April 2nd, www.energywatch.org.uk/media/news/show_release.asp?article_id=1093.
[2] energywatch (2008), 'Why the British Markets in Gas and Electricity Require a Competition Investigation', March.
[3] See, for example, Wilson, C. and Waddams Price, C. (2005), 'Irrationality in Consumers' Switching Decisions: When More Firms May Mean Less Benefit', University of East Anglia.
[4] Ofgem (2007), 'Domestic Retail Market Report: June 2007', July 4th, www.ofgem.gov.uk/Markets/RetMkts/Compet/Documents1/DRMR%20March%202007doc%20v9%20-%20FINAL.pdf.
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[10] Electricity data from Ofgem's domestic retail market report, March 2007. Gas data from Table 2.5.1: Percentage of Domestic Gas Customers by Region by Supplier Type, and Table 3.5.1: Percentage of Domestic Gas Customers by Region by Supplier Type for the First Quarter of 2007. BERR, 'Quarterly Energy Prices: December 2007', http://www.berr.gov.uk/files/file43302.pdf.
[11] http://stats.berr.gov.uk/energystats/qep251.xls. Similar electricity data is available at: http://stats.berr.gov.uk/energystats/qep241.xls.
[12] Crooks, E. (2008), 'Lack of Wholesale Competition Blamed', April 9th, www.ft.com/cms/s/0/a09de1c6-05c6-11dd-a9e0-0000779fd2ac.html.
[13] www.energywatch.org.uk/help_and_advice/saving_money/index.asp.
[14] energywatch (2008), 'energywatch Says Fuel Poverty Announcement Fails Needy Consumers', April 11th, www.energywatch.org.uk/media/news/show_release.asp?article_id=1095.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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