

Consultation Response to Proposals on a Roadmap for Deregulation – CER/09/189

by Paul Gorecki, Pete Lunn, Seán Lyons and Laura Malaguzzi Valeri of the Economic and Social Research Institute, 1 February 2010.

Introduction

We are grateful for the opportunity to respond to this CER consultation paper. Given the completion of wholesale market arrangements in the form of the SEM and the *de jure* liberalisation of electricity supply, it is an opportune moment to consider where market developments may lead and what changes will be required to the regulatory framework as retail competition becomes increasingly effective.

In our response to the consultation paper, we focus on a subset of the questions posed. These are areas where we feel our research can cast additional light on the choices being considered.

Q1: Appropriateness of setting up a market review process

We welcome CER's initiative to put in place a roadmap for deregulation. In a sector characterised by former statutory monopolies and persistent market failures such as externalities and areas of natural monopoly, retail price regulation can play a useful role in advancing the ultimate goal of economic regulation: improving societal welfare. It is not necessarily the case, as suggested in the ERGEG paper cited on pp.9-10 of the consultation paper, that end-user price regulation necessarily "jeopardises both security of supply and the efforts to fight climate change"; whether it does those things depends upon the design of the price regulation instrument. However, in markets where competition has become effective, there are benefits to withdrawing price control. Competition provides direct encouragement for efficiency and innovation that even a well-designed price control mechanism will find difficult to sustain given the informational advantages held by regulated firms.

Once one accepts that there may come a point at which it is better to remove price control in a given market, there are further benefits to putting in place a credible, transparent mechanism for determining when this should happen. Decisions about market entry, service innovation and investment in associated infrastructure are affected by expectations about future regulatory arrangements. Firms may be inefficiently deterred from undertaking such activities if there is substantial uncertainty about the regulatory environment and market conditions that will apply after the investment is made. The best way to reduce this uncertainty is by putting rules in place that are transparent and credible (in the sense that they are reasonable and the CER has no reason to diverge from the results of the mechanism as they change over time).

With an appropriate deregulatory mechanism in place, all market participants will be able to make more efficient decisions, taking into account the likelihood that each market will or will not be subject to price regulation in future periods. This benefit of greater certainty will apply to markets that are not deemed ready for lifting of price controls as much as it does to those that are fully deregulated.

In markets that are effectively competitive, lifting price controls can help to encourage innovation and price competition. However, we note that the scope for

significant benefits from deregulating retail electricity supply markets may be limited by the relatively small share of the value chain accounted for by the supply segment, in comparison to generation (already liberalised) and transmission/distribution (regulated natural monopoly).

One specific area where liberalisation of prices may be helpful is in facilitating customers who might wish to adopt tariffs that are better aligned with wholesale prices. This encourages customers to limit consumption at times of peak demand and high wholesale prices and leads to a decrease in peak demand and lower average electricity wholesale prices.

Holland and Mansur (2006), among others, have shown that the efficiency effects of aligning retail with wholesale prices can be obtained even when alignment is not perfect. The authors simulated the electricity market in Pennsylvania and found that when domestic rates varied on a monthly basis there was a significant increase in efficiency. In fact about 30% of the maximum potential efficiency gains (reached when moving to real-time pricing) could be captured by varying flat rates monthly instead of annually.

Q2-4: Definition of relevant markets

Market definition provides the appropriate frame of reference within which the degree of competition can be assessed. It is therefore a vital first step in market analysis. As the European Commission's ("EC") *Notice on the Definition of the Relevant Market for the Purposes of Community Competition Law* ("Market Definition Notice") states,

"The objective of defining a market in both its product and geographic dimension is to identify those actual competitors of the undertakings involved that are capable of constraining those undertakings' behaviour and of preventing them from behaving independently of effective competitive pressure (paragraph 2)."

Section 2 of the Commission's roadmap is concerned with defining the relevant market. The Commission concludes that there are four relevant markets;

- Large Energy Users,
- Medium sized businesses,
- Small business and,
- Domestic.

Respondents are asked whether they agree that these four markets are separate relevant markets, whether public lighting should be considered a relevant market on its own and whether all domestic customers should be considered part of the same relevant market. We consider each in turn.

Four Markets and Some Methodological Problems

The Commission's approach to market definition draws on the widely accepted guidance set out in the EC's *Market Definition Notice*. This is the SSNIP (Small but Significant Nontransitory Increase in Price") or hypothetical monopolist test. A market is defined as the smallest number of products (or services) for which a hypothetical monopolist of those products could profitably raise price 5 to 10% on a sustainable basis above the competitive level, all other things being equal. If

customers switch in sufficient numbers to alternative products the price rise will not be profitable. Additional products are then added until a price rise is profitable.

Typically demand side criteria are much more important than supply side criteria. Demand side substitutability “constitutes a much more immediate and effective discipline on the suppliers of a given product, in particular in relation to their pricing decisions” (ibid, paragraph 13) than supply side substitutability, with the latter taken into “account at the assessment stage of competitive analysis” (ibid, paragraph 14). A variety of different types of evidence can be used to assist in market definition, such as evidence of past substitution, views of customers and competitors, consumer preferences, switching costs, price correlation and so on.

In applying the EC’s framework to market definition, the Commission follows a consistent approach for each of the four markets set out above. On the demand side the Commission considers customer classification, market opening, pricing, countervailing buyer power, while on the supply side two issues are considered, conditions of supply and the economics of supply. The Commission’s approach does not entirely accord with the EC’s framework and hence there is a risk that an incorrect market definition will result.

In defining each of the four markets, the Commission is answering the following question in the affirmative: will a hypothetical monopolist of (say) large energy users be able to profitably raise the price of electricity by 5-10% above the competitive level? In this context customer classification using Distribution Use of System tariff categories is relevant since it suggests that different groups of customers have different characteristics, which is consistent with pricing discussion. However, the relevance of the discussion of market opening to the issue of market definition is not obvious, except that it might provide some information as to the extent to which the current price is the competitive price.¹

The most important shortcoming, however, of the Commission’s approach to market definition is the inclusion of countervailing buyer power. This is not usually part of market definition and the Commission provides no explanation for its approach. Rather countervailing buyer power forms part of the discussion of competitive effects. For example, in the EC’s recent guidance on exclusionary conduct by dominant firms, countervailing buyer is discussed in the context of “constraints imposed by the bargaining strength of the undertakings’ customers.”² Countervailing buyer power is concerned with the degree to which buyers can prevent a supplier from raising price above the competitive level.

In defining a relevant market it is assumed that the hypothetical monopolist can raise the price by 5 to 10% and the issue is whether or not customers switch in large enough numbers to close substitutes to make that price rise unprofitable. No account is taken in market definition of whether the buyers can defeat that price increase. In other words, countervailing buyer power is an important issue but the Commission

¹ If prices reflect the exercise of market power they cannot be relied upon for the purposes of market definition and result in too broad a market definition, sometimes referred to as the cellophane fallacy. For further discussion see Geroski and Griffith (2003).

² EC (2009) *Guidance on the Commission’s enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings*. C(2009) 864 Final. Brussels: Commission of the European Communities, paragraph 8. Geroski cited in the previous footnote adopts the same procedure.

have put it in the wrong box – it should be part of the discussion of Section 5 and Section 6 of the Commission’s roadmap that deals with relevant market analysis and other criteria for determining a competitive market, respectively.

In discussing demand side substitutability more attention should be paid by the Commission to switching behaviour. The discussion of pricing seems to be suggesting that it is not possible. For example, if the hypothetical monopolist of small businesses raises price by 5 to 10% that these firms cannot form a joint buying group and become classified as a medium or large user to avail of lower prices. Could say, a shop on the ground floor with a separate business – e.g. a hairdresser - on the first floor combine to become a medium sized business? If such behaviour is not possible then the Commission needs to state this explicitly. If it is then it is possible that there may be a chain of substitution effect that means the market definition is wider than suggested by the Commission.³

On the supply side the discussion needs to explore more thoroughly whether or not it is possible to switch easily incurring no sunk costs from one market to another or one customer group to another. This has been referred to as uncommitted entry, since no sunk costs are incurred in such entry. In the EC’s *Market Definition Notice*, supply side substitution is illustrated by a paper making machine that can switch production easily, quickly and cheaply between different grades of paper that may, from a demand side perspective, be in separate markets. However, because of this supply side substitution the EC would put all these grades of paper in the same market (ibid, paragraph 22).

The Commission’s discussion of supply side substitution suggests that serving the different markets requires some sunk costs to be incurred and that switching is not easy and effortless. In the case of supply side substitution of whether or not business and domestic consumers are in different markets, for example, it is clear from the description on page 30 that entering the market for domestic consumers entails developing a range of innovative products, which will entail some sunk costs. It is not clear, however, how relevant to the issue of market definition is the fact that there are low margins in domestic supply, given that the hypothetical monopolist raises prices by 5 to 10%.

In sum while the Commission uses the EC’s *Market Definition Notice* as the basis for market definition it does not always follow the *Notice*, using concepts on occasion that are more appropriately dealt with in the discussion of competitive effects and referring to existing market conditions which often have limited relevance to the issue of market definition.

Is Public Lighting a Relevant Market & Are Certain Classes of Domestic Consumers a Relevant Market?

The Commission is seeking guidance the treatment of two groups of customers. The first group is public lighting and unmetered customers, while the second is pre-payment/credit risk consumers. The issue in the first case is whether public lighting is a separate market, in the second case whether these customers should be treated as part of the market for domestic consumers.

³ For a discussion of chains of substitution see EC, *Market Definition Notice*, paragraph 56 to 58.

There are good grounds, as set out by the Commission, as to why the demand characteristics of these two groups are different from the broader market of which they might be considered part. However, from a market definition point of view, it is unclear why it is relevant that the supply of public lighting has been practically uncontested to date (p. 34) – that surely is an issue in examining the degree of competition in the market, an issue as noted above that is dealt with in sections 5 and 6 of the roadmap.

The EC's *Market Definition Notice* has a separate discussion of different categories of customers and price discrimination. It states that:

The extent of the product market might be narrowed in the presence of distinct groups of customers. A distinct group of customers for the relevant product may constitute a narrower, distinct market when such a group could be subject to price discrimination. This will usually be the case when two conditions are met: (a) it is possible to identify clearly which group an individual customer belongs to at the moment of selling the relevant products to him, and (b) trade among customers or arbitrage by third parties should not be feasible (paragraph 43).

It would appear that both conditions are satisfied for public lighting. As noted the demand characteristics of public lighting are quite distinct thus enabling the hypothetical monopolist to distinguish this group of customers, while trading/arbitrage is, we assume, not possible. Ex-ante one might expect public lighting to have a very low price elasticity of demand, since most of the lighting needs are based on public safety. However, since 2005 public lighting use has greatly decreased. It would be interesting to know if this was due to the adoption of more efficient lighting options, or to the elimination of illegal attachments to public lighting lines.

It is not clear, in contrast, that prepayment/credit risk customers would be readily identified at the moment of selling. Prepayment customers might reveal themselves when asked what kind of service they require, while there may be methods of determining the credit record of a customer. However, in both cases should a hypothetical monopolist of either group raise the price by 5 to 10% there is nothing to prevent such consumers switching to suppliers of other domestic customers and so defeating the price increase.⁴ Hence we favour one market for all domestic consumers which will have implications for the thresholds set for removing regulatory controls by the Commission discussed below.

Q5: Method for assessing effectiveness of retail competition

The Commission in Proposal 2 lists a series of factors that are to be used in assessing the level of competition. These include the number and size distribution of firms as well as barriers to entry, expansion and exit. The Commission then asks for comments on this as a proposal for assessing competition in retail electricity markets. This is a sensible approach since it is important to get the methodology correct for assessing the degree of competition before applying it.

⁴ In the case of pre-paid customers the Commission reports that measures are being introduced to allow switching as of November 2009 (pp. 35-36).

In general the factors outlined in Proposal 2 are the standard factors that would be taken into account in assessing the degree of competition up until recent times. However, there are factors on both the supply and demand sides of the market that should be given further consideration.

First, given the discussion above, countervailing buyer power should also be included since that is likely to be a particularly important factor in determining the degree of competition for some of the business markets identified by the Commission.

Second, in evaluating the degree of competition in a market, one might want to go further than simply listing possible factors and consider possible theories as to why the market may not be competitive and whether or not the current market conditions are consistent with those theories. Broadly speaking these theories divide into unilateral and co-ordinated effects.⁵ In terms of co-ordinated effects, attention would be paid to the symmetry of firms not only in the market shares but also cost structures. Links between firms that facilitate co-ordination might also be considered, such as the fact that ESB and BGE's supply businesses share common ownership and purchase their electricity inputs from a common pool: the SEM.

Third, and more fundamentally, we recommend that the Commission take note of the rapidly expanding research on consumer behaviour. Recent findings, which we discuss in more detail below, suggest that an assessment of the effectiveness of competition may require an analysis of consumer behaviour within the market, over and above its implications for the entry, exit and expansion of firms. In short, evidence supports an increased emphasis on the demand side, as well as the supply side, and an analysis of the interaction between the two (see, for example, OECD, 2007, on competition in the EU telecommunications market).

Our main suggestion is that the Commission should take into account recent findings relating to consumer behaviour. The orthodox economic model of the consumer assumes that consumers who are offered sufficient choice will select products that are in their own best interests. The Commission's discussion of consumer decision-making presently confines itself to one example where this is apparently not the case, namely where consumers are reluctant to switch despite the availability of lower prices. Work in behavioural economics and decision science has identified a number of influences on consumer behaviour that appear to result in consumers taking decisions that are not in their own best interests, some of which we expand on below. For now, the key point is that the combined effect of such influences seems to be considerable and extends beyond reluctance to switch supplier. Using survey data from the UK electricity market, Wilson and Waddams (2007) found that 20-32% of consumers who switched supplier in order to obtain cheaper electricity actually ended up paying more, while less than 20% switched to the firm offering the highest saving.

Given these findings, if the overall goal of increased competition is consumer welfare, then the effectiveness of competition clearly depends on the degree to which competition results in good decision-making by consumers. To some extent, this may appear problematic, since it might be thought difficult for a regulator to form the view that the freely taken decisions of individuals are not in their own best interests. However, where surveys identify that consumers whose stated aim was to secure a

⁵ These theories are discussed in a number of places. See for example, EC, *Guidelines on the assessment of non-horizontal mergers under Council Regulation on the control of concentrations between undertakings*, OJ C 265, 18 October 2008.

lower price in fact signed up to a higher one, the poor quality of the decision seems unarguable.

The Commission should therefore consider the adoption of indicators relating to the quality of consumer decision-making, to complement those that indicate the extent of switching. It is likely that the most efficient way to achieve this is through surveys of consumers, although experimental evidence on consumer decision-making also has the potential to contribute.

An important point to note here is that while the presumption is often made that business customers will be less prone to poor decision-making, there is presently a lack of evidence relating to the quality of decisions made by business customers. Despite this limited evidence, it is a reasonable presumption that the smallest businesses exhibit similar biases to domestic consumers.

One clear goal is to increase supplier efficiency and thereby reduce the retail margin. Notwithstanding the quality of consumer decision-making, a prerequisite already identified by the Commission is that a sufficient number of consumers are willing and able to switch suppliers, making it optimal for suppliers to compete, through price, quality (i.e. type of contracts) and/or marketing.

The Commission emphasises the rapid change in the incumbent's market share following the introduction of competition in 2009. However, the current rate of switching to BGÉ may not be good indicator of the likely rate of switching to other firms in future. One influence thought to reduce switching is the "status quo" bias first identified by Samuelson and Zeckhauser (1988), whereby decision-makers display a strong bias towards pre-existing or default options. Evidence suggests that the strength of this bias varies with the degree of uncertainty (in this case relating to price, service quality, ease of switching and likelihood of firm survival) that decision-makers perceive to be associated with their alternative options. This finding is matched in the UK electricity market, where Chang and Waddams (2008) found that the expected gains from switching are less of an influence on consumers' decisions to become active than the *confidence* they have in their expectations. In the case of BGÉ, such uncertainty is likely to have been greatly reduced by the fact that BGÉ is a widely recognised and established firm with whom consumers already conduct regular business. Thus, when considering the rate of change of market share as an indicator of the effectiveness of competition, the rate of switching to BGÉ is likely to be a considerable overestimate of future switching to other firms. The rate of switching to Airtricity may be a better guide.

Not surprisingly in the presence of switching costs incumbents tend to have higher prices than new entrants. This suggests that even in countries with large residential switching rates, consumers who do not switch might actually be worse off than under a regulated regime (Brennan 2007; Pomp and Shestalova 2007). It might be important to measure not only the switching rate, but also the rate at which consumers renegotiate with their current supplier. In Sweden the switching rate in 2008 was 11%, with an additional 16% renegotiating with their existing supplier.⁶

The effect of the number of competitive suppliers is not clear cut. There is evidence, especially in Great Britain, that regional incumbents maintain market power in their 'home' area whereas they offer more competitive prices and contracts when engaging

⁶ Swedish 2009 submission to the European Regulators' Group for Electricity and Gas (ERGEG).

on ‘outside’ turf (Waterson 2003). This means that the number of competitors should be calculated separately for each geographic area if not all suppliers provide electricity across the whole country. Even having a fairly large number of suppliers is not sufficient to guarantee effective competition. In Denmark there were 44 regional incumbents and 4 independent suppliers in 2008, and yet the switching rate in 2008 was still below 3% for the residential market.

Q6 and 7: Current level of competition & Barriers to entry & expansion

In Section 6 of the Commission’s roadmap a framework for assessing competition is developed (see above). It is then applied in Section 6 with respect to the number and size distribution of firms and in Section 7 with respect to other criteria for determining a competitive market. At the end of Section 6 the Commission asks in Q6 if “there is sufficient activity to consider the removal of the regulatory controls in that market”, while at the end of Section 7 the Commission asks in Q7 for respondents “to comment on the assessment of the barriers to entry, exit and expansion with the retail electricity market.” Such an approach is inconsistent with the methodology that the Commission has set out for determining whether a market is competitive which includes – quite correctly – both the number/size distribution of firms *and* barriers to entry, expansion and exit. Hence in considering whether or not there is sufficient evidence to determine if a market is competitive or not, the discussion in both Section 6 and 7 of the roadmap should be taken into account.

Q7: Barriers to entry, exit and expansion

One obvious barrier to entry and expansion, as the Commission rightly recognises, is the ease of switching and the extent of customer churn. Firms are very likely to take account of both in forming their business plans. Thus, the supply side and demand side interact, as firms’ perceptions of consumer behaviour will influence their likelihood of entry, expansion or exit.

The concerns expressed by some suppliers about the ESB brand, which the Commission raises in this context, provide a good example. Although it is only recently that economists have begun to understand better the role of uncertainty in consumer decision-making, firms are well aware of the power of a recognised brand, which can alter the consumer’s perceived uncertainty and make a switch more or less attractive. Thus, potential entrants may be deterred from entry by the existence of such powerful brands in the market, because of the chilling effect of such brands on consumers’ propensity to switch. This argument is consistent with the rapid increase in market share of BGÉ in 2009, as discussed above. However, more research is needed into whether this is a material factor in deterring switching in Irish utilities markets. Other anecdotal evidence, such as the apparent lack of increased competition when Telecom Éireann was rebranded, leaves some doubt as to how significant this factor might be compared to other reasons consumers resist switching.

As mentioned previously, switching costs are an important barrier to entry for new suppliers. It should be explicitly recognised here that there will always be some cost to switching. Even where no financial costs are incurred, consumers incur costs associated with the time and effort of arranging a switch and cognitive costs associated with information processing and coming to a decision. There is evidence to suggest that these costs matter for consumer behaviour and the degree of effective competition will therefore be influenced by them.

Reductions in non-financial costs are likely to be strongly related to the nature and salience of information available to consumers. It is important to recognise that more information does not necessarily mean more active consumers. Evidence across a range of markets suggests that where decisions involve too many options or too much information on each option, they become less inclined to be active and more likely to make poor decisions (Wilson and Waddams, 2005, in the UK electricity market; Frank and Lamiraud, 2008, in the Swiss health insurance market). These two findings are doubtless related: faced with a more complex decision, a consumer is likely to assume, correctly, that they are more likely to make a mistake and so to be less inclined to proceed.

Cognitive costs are also likely to be reduced where consumers already have experience of switching in other similar markets. Chang and Waddams (2008) found that customers in the UK who had switched in other markets were more likely subsequently to switch electricity supplier. This is an important consideration in Ireland, where experience of switching in utility markets remains relatively low.

Lastly, one important influence on switching behaviour is likely to be simple inertia. Given the very large number of potential decisions any individual could take that would be likely to save them money or improve their welfare, a substantial proportion will simply fail to get around to switching electricity supplier. It is well established that default setting is a powerful influence on behaviour (see Goldstein et al., 2008). This in part reflects “status quo” bias, in part because many default offers can be seen as implicit advice, but is also largely due to inertia.

The Commission lists the measures it intends to use to determine the level of competition in the domestic and small commercial market. In addition to these we think that the Commission should also monitor consumer behaviour through a series of surveys that address switching rates, switching costs, other impediments to switching and price renegotiation rates (if any).

Q8: Appropriateness of proposed thresholds

Our response to this question focuses on two important elements, the method used to calculate market shares and the threshold proposed to assess effectiveness of competition in the domestic market.

Calculation of market shares

Throughout the consultation paper, market share is calculated as a share of load supplied (in GWh). Revenue shares are probably a more appropriate metric for electricity supply. No rationale is given for the approach chosen, and we think it should be reconsidered. In most markets with homogeneous goods, pricing is per unit of goods supplied. Thus the share of value associated with a particular firm’s business is broadly proportional to its share of total quantities it supplies, leaving aside complications such as discounting. In contrast, electricity charges in Ireland typically have two parts: a standing charge and a charge for energy. If competitors all offer broadly the same balance between standing charges and energy tariffs *and* they all attract a similar mix of customers by level of demand, then load shares and revenue shares will be similar.

However, there are two reasons why this may not happen. First, new entrants are likely to attract customers with higher average electricity usage than the incumbent, both because such customers tend to be more prone to switching and because

marketing efforts will target them where possible.⁷ Thus even if they apply a schedule of fixed and variable tariff rates similar to the incumbent's, entrants will tend to have a higher share of revenue from variable energy charges. If this is so, they will make less revenue per GWh than the incumbent does, simply because they have fewer customers per GWh than the incumbent has. This implies that market shares based on GWh will tend to overstate the share of revenue obtained by entrants.

Second, suppose in the future some competitor offers a low standing charge. Unless it matches this with a higher charge for energy, this firm will make less revenue than its load share suggests. The general point here is that a market share measure based on revenue is robust to heterogeneity or changes in the mix of fixed and variable charges that are applied. Use of a metric that concentrates on only one driver of revenue (load or number of customers) could lead to incorrect inferences about market power or (perhaps worse) to an incentive for the market share formula to influence the pricing behaviour of firms.

Proposed market share threshold for the domestic market

It is reasonable to continue to apply retail price regulation in electricity supply markets until such time as they become effectively competitive. Partly because governments originally created incumbents' dominance through statutory monopoly, and partly because of the stickiness of consumer demand discussed elsewhere in this submission, a need for intervention may persist.

We agree that a dominance-related market share test may reasonably form part of a test for effectiveness of competition. The proposed thresholds for LEU, medium-sized business and small business segments are in line with established practice. However, the higher proposed threshold for the domestic market does not seem appropriate and we suggest that it be reconsidered.

The consultation paper suggests that a proportion of the market may be un-contestable due to many households' unwillingness to switch, implying that it may be impossible to meet a 40-50% market share threshold. Earlier in this response, we have referred to some of the evidence for limited switching and to reasons why many households are disinclined to switch.

However, it is not the purpose of this test to ensure that deregulation of a specific market may proceed now, or indeed at any time. Deregulation is not an end in itself: it is a means to improving societal welfare. It can only fulfil this function when competition is effective and the lingering effects of statutory monopoly have been removed.

So the objective of this test should not be to find some subset of potentially active domestic customers for whom competition is effective and deregulate the market for their benefit, to the disadvantage of some (perhaps larger) group of inactive customers. Brennan (2007) sets out a model of how deregulating a market with a sizeable set of inactive customers can reduce welfare.

⁷ European Commission (2009) shows evidence that switchers tend to be larger consumers, for all countries for which this information is available. The percentage of the electricity load provided by new suppliers, presented in Table 2.1 is larger than the percentage of customers with new suppliers, shown in Table 2.2. The same is also true for Ireland, as shown in the CER's own report.

By way of a simple thought experiment, suppose that only 10% of customers in the domestic market would consider switching, and that due to extremely high switching costs or other barriers to switching the remaining customers would stay with the incumbent. Deregulating prices in such a market would leave 90% of customers with the incumbent, for whom charging retail prices well above cost would be a profit-maximising strategy. It would certainly be in a position to act independently of competitors and customers, as per the *United Brands* definition of dominance cited in the consultation paper. In such a market, societal welfare would not be best served by CER deregulating prices when entrants' market shares rose above 6%, even though the incumbent would then hold less than 40% of the contestable market. Instead, in such an extreme case the regulator's best response might be to undertake structural reforms aimed at changing consumers' default supplier (discussed under Q11/Q13 below).

We suggest that the same market share thresholds should apply to the domestic market as to the other markets. As discussed elsewhere in this submission, CER should also examine the determinants of switching behaviour and the possible effects of providing simplified customer information. There are even ways to allow switching by vulnerable customers served by the Free Electricity Scheme, or other social welfare measures; for example, by providing such supports as transferable vouchers. These avenues might allow for development of microeconomic measures aimed at reducing un-contestability, as opposed to treating it as an exogenous characteristic of the market that is irrelevant to the need for regulation. The reasons for uncontestability are relevant, and should be addressed.

Q11 and Q13: Whether to change the principles of regulation / Other consumer protection measures

Given the recent evidence supplied by behavioural economics and decision-science with respect to consumer decision-making, a debate has begun internationally about possible responses by regulators (see, for example, OECD, 2007; Federal Trade Commission, 2007; Australian Productivity Commission, 2008). This debate is in the early stages and new suggestions for possible policy responses are appearing regularly. We would urge the Commission to consider ways to incorporate this expanding research area into its work, as the arguments are relevant to any process of deregulation and it is only possible to give a flavour of them here.

That said, the overriding message coming from this research is that the effectiveness of competition depends on the quality of consumer decision-making within the market, irrespective of the industrial market structure. In other words, while a high number of suppliers in markets with low concentration may be advantageous to consumers, it is not a sufficient criterion for effective competition.

Given this, there is a clear argument for consumer protection designed to assist consumers in taking decisions. Perhaps the foremost proposal is that price deregulation be accompanied by what is referred to a "mandated disclosure". This amounts to a regulatory requirement on companies to provide price and service information in a standard format designed for optimal impact on consumer decisions. Note that this is likely to involve limiting the amount of information provided, to avoid excessive complexity, and insisting on a user-friendly format. One advantage of mandated disclosure is that it can be easily tested and improved by experimental methods or pilots in small areas.

If persistent lack of switching were deemed likely to leave the incumbent supplier in a dominant position for an indefinite period, a further possible policy response is to impose a structural remedy that alters the default supplier. In other words, it may be possible on a once-off basis to require consumers actively to choose whether to stay with their supplier or to switch suppliers, in an attempt to overcome inertia. Those who decline to respond can be assigned a supplier by an appropriate mechanism (or even random selection). For a detailed discussion of appropriate policies on default options, see Goldstein *et al.* (2008). Imposing such a remedy in Ireland would probably require primary legislation.

To the extent that it reduces retail margins, retail electricity deregulation transfers welfare from suppliers to consumers. However, in practice there are different types of consumers and so issues of equity are raised, as well as those of market efficiency. In particular, consumers with a low propensity to switch are likely to face a decrease in welfare with respect to more active consumers. The Commission notes that consumers who switched in 2009 tended to have a higher consumption profile. While those with higher consumption are in line to make the greatest savings from switching supplier, they are also likely to be in higher socio-economic groups (see Scott *et al.* 2008). It therefore seems appropriate to monitor the price and conditions of the default contract in the residential sector.

A further option that might permit incremental deregulation of the residential market while protecting consumers is to change the form of the price control. Here it is useful to distinguish between two abuses that *ex ante* price controls may be used to prevent: excessive pricing (price too high) and price squeezes or predatory pricing (price too low). We consider excessive pricing to be the greater threat in this case, not least because it is a common concern in markets with switching costs. In Klemperer's words: "switching costs generally raise prices and create deadweight losses of the usual kind in a closed oligopoly" (Klemperer, 1995). Excessive pricing is also difficult to address using *ex post* remedies, such as those available in competition law. In contrast, anti-competitive practices that involve prices being too low may be of lesser concern, and are more amenable to *ex post* regulation or competition enforcement responses.

Changing the form of the price control could allow these two issues to be handled separately, potentially providing more pricing flexibility to the incumbent without compromising protection against excessive pricing. If entry conditions and the scope for *ex post* regulatory action were deemed sufficient to protect against predatory pricing behaviour by the incumbent, but entrants' market shares and the size of the contestable market were considered too low to protect against excessive pricing, CER could consider removing the implicit restriction on below-cost pricing while retaining a price cap. In other words, CER could cease approvals of specific price changes and apply only a multi-year cap, perhaps with a backstop measure such as a requirement to set prices above marginal cost. Multi-year price caps can also provide incentives for the incumbent supplier to control costs in a way that it is difficult to do with an annual price approval mechanism.

References

Australian Productivity Commission (2008). *Review of Australia's Consumer Policy Framework*, Final Report, Canberra.

- Brennan, T. (2007) Consumer preference not to choose: Methodological and policy implications, *Energy Policy*, 35, 1616-1627.
- Chang and Waddams (2008). *Gain or Pain: Does Consumer Activity Reflect utility Maximisation?* ESRC Centre for Competition Policy Working Paper No. 08-15.
- European Commission (2009) Report on Progress in Creating the Internal Gas and Electricity Market: Technical Appendix, Technical Appendix to EU COM(2009)115.
- Federal Trade Commission (2007). *A Conference on Behavioral Economics and Consumer Policy*. <http://www.ftc.gov/be/consumerbehavior/docs/agenda.shtm>.
- Geroski, P & R. Griffith (2003) "Identifying Anti-trust Markets," in Geroski, P. 2006. *Essays in Competition Policy*. London: Competition Commission, pp. 4-13.
- Goldstein, Johnson, Herrmann, and Heitmann (2008). *Nudge Your Customers Toward Better Choices*. *Harvard Business Review*, 86(12), 99-105.
- Holland, S. and E. Mansur (2006) The Short-Run Effects of Time-Varying Prices in Competitive Electricity Markets, *The Energy Journal*, 27(4), 127-156.
- Johnsen, T.A. (2003) Residential customers and competitive electricity markets: the case of Norway, *The electricity journal*, 16 (1), 74-79.
- Klemperer, P. (1995) Competition when consumers have switching costs: an overview with applications to Industrial Organisation, Macroeconomics, and International Trade. *The Review of Economic Studies*, 62, 515-539.
- Littlechild, S. (2006) Competition and contracts in the Nordic residential electricity markets, *Utilities Policy*, 14, 135-147.
- OECD (2007). Enhancing Competition in telecommunications: protecting and empowering consumers. <http://www.oecd.org/dataoecd/25/2/40679279.pdf>.
- Pomp, M and V. Shestalova (2007) Switching costs in the Netherlands energy markets: can liberalization bring benefits to small customers?, *De Economist*, 155, 305–321.
- Samuelson and Zeckhauser (1988). Status Quo Bias in Decision Making. *Journal of Risk and Uncertainty*, 1, 7-59.
- Scott, S., S. Lyons, C. Keane, D. McCarthy and R.S.J. Tol (2008) Fuel Poverty in Ireland: Extent, Affected Groups and Policy Issues, ESRI Working Paper 262.
- Waterson, M. (2003) The role of consumers in competition and competition policy, *International journal of industrial organization*, 21, 129-150.
- Wilson and Waddams (2005). *Irrationality in Consumer's Switching Decisions: When More Firms May Mean Less Benefit*. ESRC Centre for Competition Policy Working Paper No. 05-4.
- Wilson and Waddams (2007). *Do Consumer's Switch to the Best Supplier?* ESRC Centre for Competition Policy Working Paper No. 07-6.