29 June 2018

A large number of households are missing out on the benefits of competition

Entrust is concerned about the large number of households missing out on the benefits of competition, because of the exploitative behaviour of incumbent retailers.

The Saves & Winbacks (S&W) Issues Paper's claim the retail market is well-functioning is difficult to reconcile with its observation 42% of residential consumers are paying more for electricity because they haven't attempted to switch supplier. In well-functioning markets all consumers benefit from competition regardless of whether they remain loyal to their supplier or switch.

Entrust wants electricity to be supplied in an efficient and affordable way to all consumers, including the over 327,000 households and businesses in Auckland, Manukau and parts of Papakura and eastern Franklin that are beneficiaries of Entrust.

Summary of Entrust's concerns

- Entrust considers that competition in electricity retailing is weak: There is a high degree of market concentration, which is only being slowly eroded, with the 5 largest incumbent retailers controlling 89% of the market.
- The large incumbent retailers are successfully partitioning the market between their competitive, "switchers", and virtual monopoly, "stayer", customer bases.
- The result of incumbent retailer price discrimination is that they are able to charge a large segment of consumers excessive prices – something like overcharging by $360 million dollars per annum.[1]
- Based on UK and NZ surveys the consumers who are paying too much are over-represented by low income households and the elderly, who can least afford high electricity prices.
- Entrust believes the incumbent retailers have been able to pervert normal competitive market outcomes, where all consumers benefit from competition, by adopting increasingly aggressive and predatory Saves and Winbacks strategies.

Incumbent and entrant retailer positions on saves and winbacks is revealing

There is a clear dividing line between incumbent retailers and new entrant retailers on this topic.

This is evident from previous Electricity Authority consultation on S&W.

All incumbent retailers opposed restrictions on S&W, while all entrant retailers supported restrictions. While these positions reflect vested interests, the interests of entrant retailers, who would benefit from a more competitive market, are most closely aligned with consumers and households.

[1] This figure was suggested by Electric Kiwi in a RadioNZ interview. The CEO of the Electricity Authority was in the same interview and did not dispute this value. Source: Radio NZ – National, Nine to Noon, interview by Kathryn Ryan with Luke Blincoe (CEO, Electric Kiwi), Carl Hansen (CEO, Electricity Authority) and Sue Chetwin (CEO, Consumer NZ), about why small electricity retailers say the system is unfair and restrains competition, 26 June 2018.

Given the contentious nature of the issue and the potential revenue at risk for incumbent retailers (the excess prices "stayers" are incurring) we consider it would be advisable to include opportunity for cross-submissions on this topic.

There is a general problem with weak competition in electricity retail

Entrust is concerned competition in the electricity sector isn't delivering the benefits to consumers, particularly lower prices, it should.

The large number of retailers, and retail brands, which has been trumpeted by some parties as evidence the retail market is competitive, mask the reality that 89% of the market is still supplied by only 5 incumbent retailers. It is clear there are problems with high levels of market concentration.

While there have been improvements in competition these have been modest and slow. Small and new entrant retailers have gained little more than 1% market share per annum since 2010. We would expect to see new entrants gain market share faster than this in a well-functioning market. Consumers deserve better.

The Saves and Winbacks problem mirrors other sectors where there are competition problems

There has been a lot of coverage about pricing strategies in the retail petrol sector which parallel what we are seeing in electricity.

What is clear is that in regions where there is more competition, with the likes of Gull and NPD in the market, we see lower petrol prices than in areas with stronger oligopolistic characteristics.

This has resulted in higher retail petrol prices in Wellington than in the Kapiti Coast (Levin) even though Wellington is supplied by a port and costs are lower. Similarly, prices in areas north of Christchurch, such as Amberley, are cheaper than in Christchurch.

The Government's review of petrol pricing found evidence these lower prices are being funded by higher prices or subsidies from less competitive regions.[2] The S&W review should consider whether the same is happening in electricity retail.

What we are seeing in the petrol and electricity retail markets doesn't reflect well-functioning markets. Instead it highlights problems with oligopolistic markets and that consumers would benefit from increased competition.

Incumbent retailers are using market partitioning to exploit their virtual monopoly customer bases

Incumbent electricity retailers are successfully price discriminating between competitive customers (so called "switchers") and their virtual monopoly customers ("stayers") within each network region they are the incumbent in. The incumbent retailers have been successful at perverting normal workably competitive market outcomes to stop consumers benefiting from competition unless they seek to switch retailer.

The size of this problem could be very substantial for consumers. The S&W Issues Paper indicates that over 40% of residential consumers have never switched.

[2] http://www.mbie.govt.nz/info-services/sectors-industries/energy/liquid-fuel-market/fuel-market-financial-performance-study-2017

On top of this, there will be consumers who haven't moved for a long period of time. The indications are that this could translate to residential consumers overpaying by $360 million dollars per annum.[3]

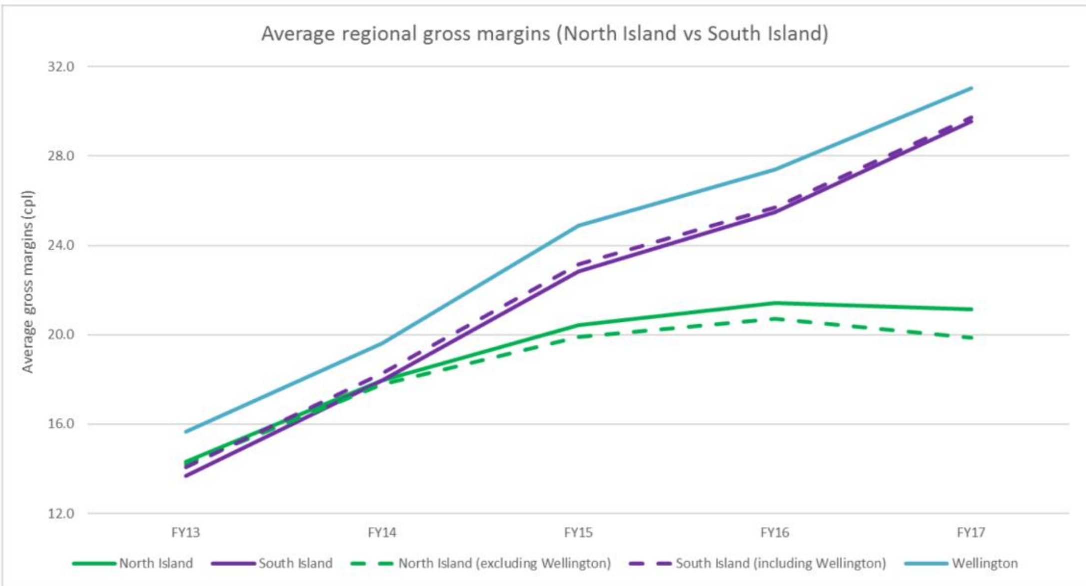
Entrant retailers have been clear the incumbent retailers have been able to keep prices high, without losing large numbers of customers, by adopting increasingly aggressive and predatory S&W strategies.

The result is a large segment of customers ("stayers") missing out on the benefits of competition and paying non-competitive (excessive) prices. We cannot see any legitimate basis in the Issues Paper for the conclusion "Evidence suggests the market is functioning as one would expect a competitive market to function".[4] The evidence suggests the opposite.

The Electricity Authority should be able to use its information gathering powers to quantify the size of this problem. While the Issues Paper acknowledges price, differentials exist the differential needs to be quantified to determine the scale of the problem. This should be done as part of the S&W review's next steps.

The kind of analysis of price differentials and margins in the Government's retail petrol inquiry is missing from the S&W review. This is illustrated by the following diagram from the petrol inquiry.[5]

Figure 1 Retail gross margins



Source: data provided by majors.

[3] Refer to footnote 1.
[4] Market Development Advisory Group, CUSTOMER ACQUISITION, SAVES AND WIN-BACKS – ISSUES PAPER, 22 May 2018, paragraph 6.1.1.
[5] Cognitus, Grant Thornton, and NZIER, New Zealand fuel financial performance market study, A report to the Ministry of Business, Innovation and Employment, 29 May 2017.

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The incumbent retailers' price discrimination is made worse by exploiting low income and elderly households

UK and New Zealand reports show the households missing out on the benefits of competition ("stayers") are over-represented by low income and elderly consumers. ConsumerNZ, for example, found "vulnerable electricity consumers are getting the worst deal".[6]

The Issues Paper cited a UMR (2014) survey which found lower income consumers and the elderly were less likely to switch. It would be useful for the S&W review to commission an update the survey.

Low income and elderly consumers, who can least afford electricity, and would benefit most from stronger competition, are the ones paying the most.

According to ConsumerNZ, the reality is that we are seeing:

- 18% of households having financial difficulties paying their power bills;
- 14% of households having overdue fees added because they couldn't pay on time; and
- 15% of households cutting back on heating because of the cost of power (38% of Mercury's GLO-bug customers).

This demonstrates that low income and elderly consumers can reasonably be expected to be more price sensitive than well-off households.

This has real world implications for households and communities. What the Electricity Authority would label as "allocative inefficiency" or a "deadweight loss" is low income households and the elderly suffering from inadequate heating and all the associated health risks, such as cardiovascular disease and respiratory health problems, that go with it.

Economic efficiency has a human dimension which should not be ignored. Entrust would like to see recognition that promotion of the long-term benefit of consumers includes health and well-being.

The sort of price discrimination we are seeing isn't efficient or beneficial

The Issues Paper asserts the sort of price discrimination we are seeing "can be beneficial for consumers overall if customers who pay lower prices are, on average, more price sensitive than those who pay higher prices".[7] If the Government wanted to downplay problems in the petrol industry it could, similarly, have suggested Kapiti Coast motorists might be more price sensitive than Wellingtonian motorists.

Over-representation of low income and elderly consumers in the "stayer" category makes the suggestion "stayers" are less price sensitive implausible. The Issues Paper's position would basically require a 'reverse Robin Hood' and for robbing the poor to give to the rich to be desirable and efficient. The opposite can be reasonably expected.

A robust and inquisitorial review would recognise that whether the price discrimination is beneficial or exploitive and inefficient is critical to the problem definition, and test this with quantified evidence.

[6] Consumer NZ, Energy providers survey, 7 June 2018.
[7] Market Development Advisory Group, CUSTOMER ACQUISITION, SAVES AND WIN-BACKS – ISSUES PAPER, 22 May 2018, paragraph 4.3.11.

OECD has recognised the type of exploitative price discrimination we are seeing in electricity retail as a problem

The OECD has investigated different types of price discrimination and distinguished between price discrimination that can be good for consumers, and price discrimination that is exploitative or distortionary.

What we are seeing from incumbent retailers is exploitative price discrimination. The distinction between stayers and switchers is the distinction the OECD make with "partitioning strategies … to distinguish between sophisticated and naïve customers".[8]

The OECD note, for example, that:

- "price discrimination between sophisticated and naïve consumers can sometimes lead to the exploitation of naïve consumers to subsidise sophisticated consumers";[9]
- "… there are … 'partitioning strategies' that can help a dominant firm … to change the profit maximising price(s)";[10]
- "These actions increase its mark-up, and, … price discrimination schemes that enable firms to raise mark-ups … also increase market power and can therefore help create "a more powerful monopoly"";[11] and
- "… partitioning strategies might … require more attention than they receive when price discrimination is interpreted by agencies as simple profit maximising behaviour." [12]

The OECD also detail "How to analyse allegations of exploitative price discrimination and partitioning strategies that facilitate it"[13] in order to "help assess whether a price discrimination scheme, and any partitioning strategies that facilitate it, is abusive or not".[14] Entrust considers it would be useful to follow the OECD's guidance as part of the next steps and development of the problem definition.

Questions that should be answered to establish the extent of the problem

Entrust would like to see the next stage of the S&W review answer the following questions:

- What is the level of price discrimination by incumbent retailers between "stayers" and "switchers"?
- What evidence is there about the price elasticity ("sensitivity") of demand of "stayers" and "switchers" and what does this mean for the "efficient" level (and direction) of price discrimination? How does the make-up of stayers (predominantly low income and elderly) impact on this?
- What level of excess returns have incumbent retailers been able to extract from "stayers"? How has this money been used?
- Have incumbent retailers' responses to competition for "switchers" resulted in higher prices to "stayers" to compensate for loss in revenue?
- Was the Electricity Authority correct when it stated the switching process gave incumbent retailers an undue informational advantage for saves and early winbacks?

[8] OECD, PRICE DISCRIMINATION, Background note by the Secretariat, 29-30 November 2016, paragraph 60.
[9] OECD, PRICE DISCRIMINATION, Background note by the Secretariat, 29-30 November 2016, footnote 48.
[10] OECD, PRICE DISCRIMINATION, Background note by the Secretariat, 29-30 November 2016, paragraph 59.
[11] OECD, PRICE DISCRIMINATION, Background note by the Secretariat, 29-30 November 2016, paragraph 59.
[12] OECD, PRICE DISCRIMINATION, Background note by the Secretariat, 29-30 November 2016, paragraph 59.
[13] OECD, PRICE DISCRIMINATION, Background note by the Secretariat, 29-30 November 2016, section 4.4.
[14] OECD, PRICE DISCRIMINATION, Background note by the Secretariat, 29-30 November 2016, paragraph 73 - 78.

Concluding remarks

The focus of our comments are unabashedly beneficiary and consumer focussed.

Entrust wants stronger and more rigorous competition. Entrust wants all consumers, including low income and elderly consumers, to benefit from competition. This isn't happening in the New Zealand electricity retail market.

Entrust wants to see the normal competitive market outcomes the Electricity Authority originally envisioned where incumbent retailers are encouraged "to preemptively offer their existing customers a better deal" and "no longer retain customers by waiting for them to initiate a switch and then carrying out a save" instead "facing an increased incentive to pre-emptively provide the customer with an improved price/service offering that will dissuade the customer from beginning the switch process in the first place".[15]

The S&W review provides the Electricity Authority with an opportunity to address some of the retail market competition problems.

There are a number of options that should be considered to improve retail competition such as:

- requirements for greater incumbent retail tariff transparency (including a requirement to advise customers whether they are on the best tariff their retailer is offering);
- a blanket ring-fencing, or Chinese Wall, requirement that information obtained from the switching process cannot be used for saves and winbacks; and
- adopting the Electricity Authority's original proposal to ban near-term winbacks.

The Issues Paper notes "There is a view that if retailers were not able to engage in win-backs, then this would put broad-based downward pressure on all prices offered by the established retailers, who serve most non-switching customers. If retailers cannot win customers back by offering them better deals, then these retailers would have to offer a lower price to more of their customers".[16]

The S&W Issues Paper models that if switch withdrawals were banned, and nothing else changed, "Most smaller retailers would benefit" and "The market share of most larger retailers would fall further".[17] This would be a start in delivering better competitive outcomes.

[15] Electricity Authority, Proposed Code amendment Saves and early winbacks, 24 June 2014, paragraph 5.3.11.
[16] Market Development Advisory Group, CUSTOMER ACQUISITION, SAVES AND WIN-BACKS – ISSUES PAPER, 22 May 2018, paragraph 4.3.7.
[17] Market Development Advisory Group, CUSTOMER ACQUISITION, SAVES AND WIN-BACKS – ISSUES PAPER, 22 May 2018, paragraph 5.3.4.

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Kind Regards

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