Are switching rates low because new entrants cannot get competitive access to sources of gas and power?

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Switching rates – especially in the market for residential and small business customers – are low almost everywhere in Europe. There are various reasons for low switching rates in the mass market. Access to sources of gas and power is only one factor which contributes to the low level of competition in most of the electricity and gas markets.

Figure 1 shows the switching rates in the mass markets of some European countries. Due to the poor data basis, switching rates can hardly be compared with each other. Even the National Reports, which are part of the Benchmarking Report of the European Commission[1], do not contain comprehensive data[2]. The markets exhibiting the highest switching rates are Great Britain, the Scandinavian countries and the Netherlands. In all other member states the switching rates are low either because of market entry barriers and a low level of competition or because energy prices are still regulated and switching is not possible or does not pay off.

Figure 1: Switching rates and average savings in selected electricity markets

Source: E-Control, Dte, STEM, Ofgem

Reasons for low switching rates and a low level of competition

There are various reasons why switching rates and the level of competition are low. The access to gas and electricity is crucial for suppliers to enter the market, but it is not the only relevant factor.

Market entry barriers – a supply-side view

TSO level – access to electricity and gas

There are three areas to look at (four in the gas market):

1. access to the commodity,
2. access to transmission capacities,

[1] COM (2006) 841 final, Prospects for the internal gas and electricity market

[2] There are two main reasons for that: Firstly, the regulators are in most cases not able to oblige the companies to supply the relevant data (lack of legal basis). Secondly, integrated companies usually have no incentive to deliver data to the regulators on a voluntary basis.

3. access to gas storage facilities,
4. liquid and transparent balancing markets.

ad 1. access to the commodity
In most of the European electricity markets there are usually no problems concerning the access to the wholesale market, particularly to the electricity wholesale market. Liquidity is high and prices are based on the interaction of demand and supply.

In the gas market there are only a few trading spots (Zeebrugge, NBP) where liquidity is higher. Most of the suppliers depend on bilateral contracts with only a few producers (Norway, Russia) and approx. 60 % of the production is located outside the EU. Vertical foreclosure is another problem; it results not only from vertical integration but also from long-term import contracts.

ad 2. access to transmission capacities
New suppliers need not only access to electricity or gas but also the capacities for transporting it to their customers. In the electricity market there are still not enough cross-border capacities even though the allocation mechanisms are largely transparent.

In the gas market transmission capacities are predominantly reserved through long-term contracts which are based on supply contracts. These long-term contracts foreclose the markets to new entrants, which are not able to supply customers despite having access to the commodity. In order to decrease market entry barriers a higher level of transparency concerning the allocation of transmission capacities is needed and a secondary market for capacities has to be established (see also EU sector inquiry – low level of market integration and intransparent market information).

ad 3. access to gas storage facilities
Even if the commodity and the capacity are available to suppliers, access to storage facilities can be crucial for supplying gas to customers.

ad 4. liquid and transparent balancing markets
When a new supplier enters a market, the customer base is small and there is little balancing between customer groups. This results in a higher risk of balancing energy for suppliers with a small number of customers. In order to reduce the expected risk for new suppliers, balancing market mechanisms have to be transparent and non-discriminatory for all market participants.

<u>DSO level</u>
Even if new suppliers have access to electricity and gas that does not automatically mean that there is a high level of competition in the downstream markets. Quite on the contrary, there are still high market shares of incumbents, a low level of competition and a low number of new suppliers in most electricity and gas markets in Europe. So, there must be additional market entry barriers for new suppliers.

When comparing vertically integrated companies to new suppliers without an integrated network company, it becomes obvious that the incumbent companies have several advantages and possibilities for discrimination:

- lower costs for customer care compared to high fixed costs in combination with a low number of new customers (e.g. billing systems),
- new suppliers are often confronted with higher transaction costs (e.g. exchange of data, no integrated data system). Integrated suppliers use the same data and can rely on the quality of the transferred information. Despite unbundling regulations, integrated suppliers often have information about new connections independent suppliers do not have (see also EU sector inquiry: unequal information and treatment).

- in order to establish a trademark, new suppliers have to invest heavily in marketing and besides they can not use a common trademark like vertically integrated suppliers. Even if there is no cross-subsidisation in monetary terms, marketing expenses of the DSO have positive effects for the integrated suppliers (see also EU sector inquiry: cross subsidisation).

The organisation of distribution system operators, Geode, argues that ownership unbundling is not an obligation for the DSO because they "*do not do not have the capacity to block markets as do TSOs*"[3]. But in contrast to the TSO, the DSO is in direct contact with the customer (of the integrated supplier) and has to exchange data and other information with other suppliers that are not integrated. As mentioned above there are several possibilities for the DSO to favour the integrated supplier.

Market entry barriers – a demand-side view
Not only supply-side but also demand-side factors increase switching cost and thereby market entry barriers.

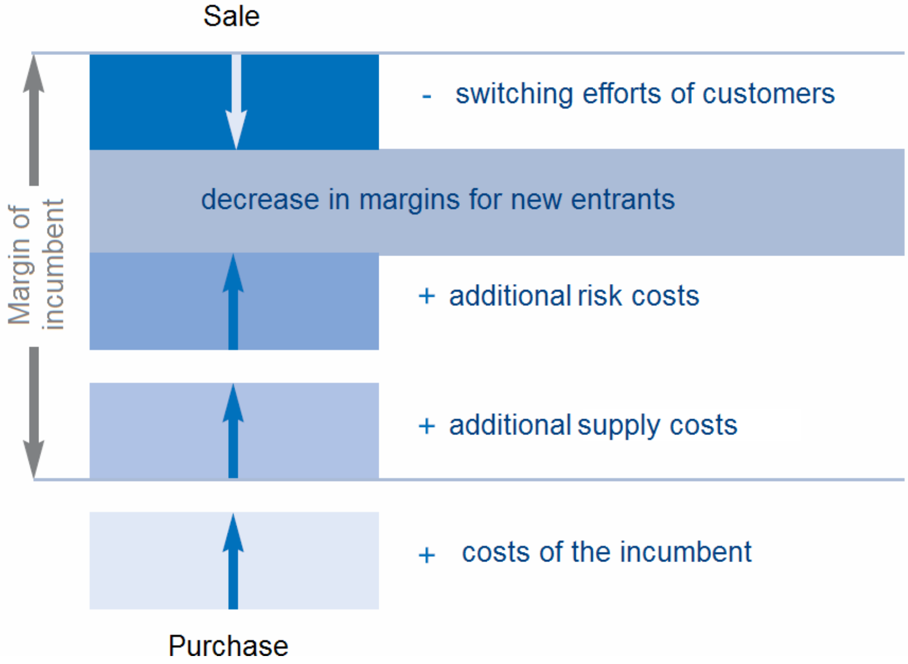
A lack of information and transparency is an important reason for the rigidity of customers even if the potential savings are high (e.g. in Austria € 70/year on average). Such intransparent market information includes, e.g.:

- intransparent billing,
- confusing information by incumbents (e.g. about responsibilities of DSO and suppliers),
- intransparent price information (e.g. all-inclusive pricing).

Small margins for new suppliers due to high entry barriers
Collecting the information necessary to feel comfortable about switching from one supplier to another requires a lot of effort and time. A lack of transparency causes high switching costs.

Market entry barriers result in smaller margins for new suppliers. As Figure 2 shows, the compensation of switching efforts of customers, additional risk costs and supply costs lead to a decrease in margins for new entrants..

Figure 2: Margins of incumbents vs. new suppliers

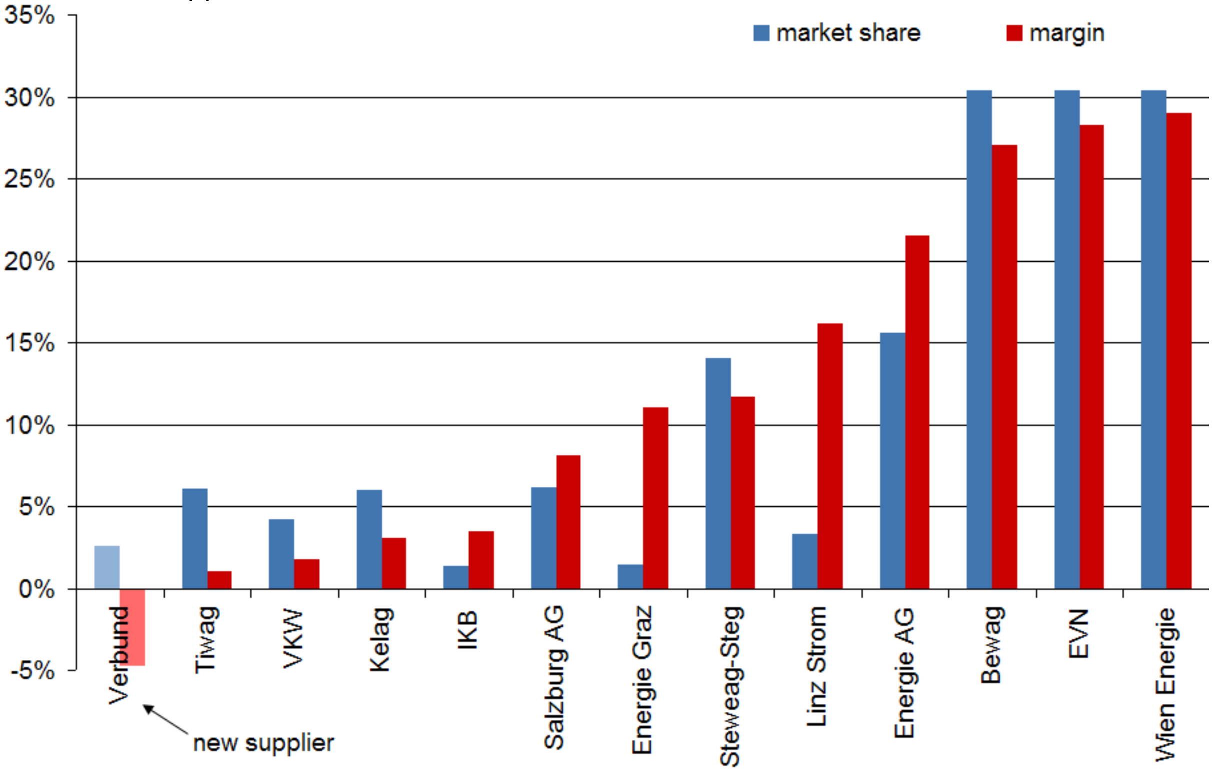


[3] EIS (27th April, 2007)

Source: E-Control

In some countries the savings potential when switching from the local player to the cheapest supplier is high (e.g. Austria, Germany). Nevertheless switching rates are low. Low switching rates in combination with a high savings potential can be indicators for market entry barriers (see also OFT-Report on switching costs)[4]. The report also stressed that the margin of an incumbent is positively related to its market share. Figure 3 shows the relation of market shares and margins in the Austrian retail market.

Figure 3: market shares (as percentage of total national consumption) vs. raw margins of different suppliers[5] in Austria



Source: E-Control

Regulated Prices

The deregulation process leading towards competitive markets varies in timing and in speed within the EU. Most Member States with open markets still offer regulated prices. This will continue even after the 1st of July 2007. Yet the main goals of free movement of goods, freedom to provide services and freedom of establishment can only be achieved in a fully open market[6]. In the long run, price regulation hinders costumer protection through competition by:

- reducing switching numbers,
- reducing demand flexibility and the incentive for price competition,
- reducing the incentives to invest,
- obstructing the creation of a dynamic market.

The tools and instruments used for the protection of vulnerable customers must be brought in line with and foster free competition. Yet this is the governments' task and not the regulators'.

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[4] Office of Fair Trading (OFT); Switching costs, Economic Discussion Paper 5, Part one: Economic models and policy implications, (page 16f), April 2003

[5] Bewag, EVN, Wien Energie retail companies are subsidiaries of one company – hence they are shown with the same market shares.

[6] Directives 2003/54/EC and 2003/55/EC preamble point 4