

## A 'striking consumer preference' for large energy retailers\*

Andrew Rendall<sup>1</sup>, James Owen<sup>1, \*\*</sup>, James Wilson<sup>1</sup>, and Niamh Keighran<sup>1, 2</sup>

<sup>1</sup> Essential Services Commission, Victoria

<sup>2</sup> Victorian Department of Treasury and Finance

When Victoria's energy market opened to full retail competition in the early-2000s, few predicted that nearly two decades later, 77 per cent of electricity customers and 85 per cent of gas customers in the state would still prefer a large retailer. Why does this large retailer preference persist?

In terms of alternatives to the large energy retailers, Victoria's residential electricity market has welcomed many new electricity retailers over the last decade, pushing the market share of large retailers down. However, economists have pointed out since the 1960s that competition is not the sole driver of customer outcomes (Stigler 1961, Stiglitz 1979, and Burdett and Judd 1983).

It has been widely recognised that retail competition can be enhanced if customers actively search for better energy deals (Varian 1980, Salop and Stiglitz 1977), leading many regulators to add measures of customer engagement to their competition assessments (AER 2007-2021 and AEMC 2014-2020), such as customer switching rates. However, the variability in customer switching rates is difficult to explain, and a customer's decision to switch retailer does not always lead to the lowest possible price. For example, academic economists point to customer characteristics and preferences as substantial drivers of outcomes (Chen and Zhang 2011 and Stahl 1996). Therefore, it may be logical that customers choose large retailers when balancing price, their own experiences of the market, convenience, and the perceived risk of choosing an unknown retailer.

To address this question, we use a range of Victorian data that captures both energy retailer and consumer behaviour. Specifically, we analyse energy retailers' offer prices, customer switching data, and other retailer reported metrics. Comparing median offers over time we establish that large retailers have tended to be more expensive. We combine this finding with data that shows a majority of large retailer customers are not on their retailer's 'best offer'. To further establish the customer preference for large retailers, we contrast observed higher prices with switching data to show that large retailers have a higher retention rate than medium or small retailers. We also show that for customers who do switch, a majority end up at a large retailer, whether they came from a small, medium or large retailer.

We provide several potential explanations for customers' large retailer preference. Some customers may incorrectly believe the lights will go out with a smaller retailer, also known as a supply risk. The customer service quality of large retailers may also be perceived as more certain. Some customers may prefer the convenience options that some large retailers offer, such as providing paper bills. Customers may value the convenience of bundling services, such as electricity and gas. Finally, economists have developed explanations linking the difficulty in engaging with the market with choosing a large (prominent) brand. For example, markets with complex pricing can lead to consumer confusion, and confused consumers tend to favour prominent brands (Chivoveanu 2019).

While consumers state in surveys that price is the most important factor when switching, large energy retailer offers are generally more costly than those offered by small and medium retailers. In addition, most large retailer customers are not on their current retailer's 'best offer'. Despite facing more costly offers, large retailer customers are more loyal, with substantially higher customer retention rates than either small or medium retailers. When customers do switch, most large retailer customers move to another large retailer, despite the lower prices offered by small and medium retailers.

We conclude that, while there does appear to be the right conditions for competition, there is a long-standing preference for large retailers. Going forward, actions that help increase customers' confidence and trust across all energy offer options will support access to the most competitive energy prices in the market.

\* The views expressed within this paper do not necessarily reflect the opinions or beliefs of the Essential Services Commission of Victoria.

\*\* Corresponding author (james.owen@esc.vic.gov.au)

## References

- Australian Energy Market Commission (AEMC), Retail energy competition review, 2014-2020, AEMC.
- Australian Energy Regulator (AER), State of the energy market report, 2007-2021, AER.
- Burdett K, Judd K, Equilibrium price dispersion, *Econometrica*, 1983, 51(4): 955-969.
- Chen Y and Zhang T, Equilibrium price dispersion with heterogeneous searches, *International Journal of Industrial Organisation*, 2011, 29(6): 645-654.
- Chioveanu I, Prominence, complexity, and pricing, *International Journal of Industrial Organisation*, 2019, 63(March): 551-582.
- Salop S, Stiglitz J, Bargains and ripoffs, *The Review of Economic Studies*, 1977, 44(3): 493-510.
- Stahl D, Oligopolistic pricing with heterogeneous consumer search, *International Journal of Industrial Organisation*, 1996, 14(2): 243-268.
- Stigler G, The economics of information, *Journal of Political Economy*, 1961, 69(3): 213-225.
- Stiglitz JE, Equilibrium in product markets with imperfect information, *The American Economic Review*, 1979, 69(2): 339-225.
- Varian H, A model of sales, *The American Economic Review*, 1980, 70(4): 339-345.

## Key Words:

Energy, Retail Energy, Consumer Preferences, Prices, Search Costs, Strategy

## Special Session Topic:

Energy Markets

## Biography of Andrew Rendall:

Andrew Rendall is the Chief Economist for the Essential Services Commission, the economic regulator of Victoria. At the commission, Andrew and his team are currently focused on energy market competition and efficiency. Previously, as the Director of Integration Science and Modelling at CSIRO, Andrew managed the technical delivery of the Australian National Outlook (2019) project that modelled Australia's economic, social and environmental outcomes through 2060. Before coming to Australia, Andrew was a Partner at ECON in Europe, with consulting experience in more than a dozen countries across five continents. He also has litigation economics consulting experience, having worked for Compass Lexecon in Cambridge, MA. Andrew has a PhD (economics) from the University of Zurich, an MA (economics) from Tufts University, and a BSc (economics) from Pennsylvania State University.

\* The views expressed within this paper do not necessarily reflect the opinions or beliefs of the Essential Services Commission of Victoria.

\*\* Corresponding author (james.owen@esc.vic.gov.au)