

Innovation, Differentiation, and Consumer Choice in the Victorian Retail Energy Market*

Andrew Rendall^{1, **}, James Owen¹, Benjamin Ryan¹, Ismini Karamesinis¹, and Joshua Clyne^{1, 2}

¹ Essential Services Commission, Victoria

² University of Melbourne

The introduction of competition to the Victorian retail energy market was expected to support better consumer outcomes through innovation and product differentiation. However, the extent to which these outcomes have been observed in the market is still unanswered and prompts the question, do Victorian energy consumers value innovation?

There is no clear consensus concerning either the level or impact of current innovation activity in the Victorian retail energy market. For example, the Australian Energy Market Commission (2015) pointed to the retailer benefits of innovative offers that meet consumer needs, particularly around consumer acquisition and retention. However, recent St. Vincent de Paul Society (2021) work points out that many retailers are offering an increasing number of offers that may not support better consumer outcomes. This may be indicative of retailer strategies aimed at making the market unnecessarily complex and confusing, to increase search costs and hence retain customers.

Even when considering specific product features, there are conflicting views. For example, when considering tariff structure innovation, CSIRO (2015), the Grattan Institute (2017) and Burns and Mountain (2020) all concluded that most consumers would be unlikely to take up offers with time varying tariffs or cost reflective pricing. However, Tayal and Evers (2018) and Energy Consumers Australia (2021) present cost-reflective pricing as an example of innovation that broadens consumers energy options, supported by positive consumer sentiment survey results. Such a divergence of conclusions can also be found in the available research regarding offer discounting (AEMC 2019 and AEMC 2020) and consumers' price preferences (ACCC 2018 and Ernst & Young 2022).

In contrast to previous research, which has been limited by data constraints and analytical scope, we use Victorian data that captures both energy retailer and consumer behaviour in 2020. Specifically, we analyse product differentiation patterns for all retail energy offers in Victoria and a large sample of consumer invoices representing about 88 percent of Victorian consumers. This research employs an analytical framework that captures all retail energy product differentiation, which is then used to quantitatively identify both retailers' product differentiation strategies and consumer preferences.

We highlight three key findings. First, the retail energy market is characterised by a relatively large volume of superficially differentiated offers that can make searching the market more difficult, potentially increasing market complexity and search costs. Second, to the extent that there is deeper offer differentiation available, it is generally more complex and may need additional consumer investment, making it unlikely to appeal to the average consumer. Third, we find that smaller energy retailers tend to specialise using a small product portfolio that is focused on a particular area, with larger retailers competing more broadly with standard product differentiation approaches. This supports the findings of theoretical models of research and development (Cabral 2003, and Rosen 1991) and models of competition in markets with product differentiation and heterogeneous firms (Kalra and Li 2008).

We conclude that, while there does appear to be evidence that Victorian energy consumers value innovation, it is not clear that the currently available products are meeting consumers' preferences.

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

** Corresponding author (andrew.rendall@esc.vic.gov.au)

References

- Australian Competition and Consumer Commission (ACCC), Restoring electricity affordability and Australia's competitive advantage: Retail electricity pricing inquiry – Final Report, ACCC, June 2018.
- Australian Energy Market Commission (AEMC), Final report: 2015 Retail competition review, AEMC, June 2015.
- Australian Energy Market Commission (AEMC), Final report: 2019 Retail energy competition review, AEMC, June 2019.
- Australian Energy Market Commission (AEMC), Final report: 2020 Retail energy competition review, AEMC, June 2020.
- K Burns & B Mountain. Do households respond to Time-Of-Use tariffs? Evidence from Australia. *Energy Economics*, 95, 105070, March 2021.
- L Cabral, 'R&D competition when firms choose variance', *Journal of Economics & Management Strategy*, 2003, 12(1): 139-150.
- CSIRO, Australian Consumers' Likely Response to Cost-Reflective Electricity Pricing, September 2015.
- Energy Consumers Australia (ECA), behavioural survey: October 2021.
- Ernst & Young, What does a customer-led energy transition mean for Australian energy?, January 2022.
- Grattan Institute, Price Shock: Is the retail electricity market failing consumers?, March 2017
- A Kalra, S Li, 'Signalling quality through specialization', *Marketing Science*, 2008, 27(2):168-184.
- R Rosen, 'Research and development with asymmetric firm sizes', *The RAND journal of economics*, 1991, X(Y):441-429.
- St. Vincent de Paul Society, The NEM - Lower prices, more offers: Are consumers reaping the rewards?, November 2021.
- D Tayal, U Evers, 'Consumer preferences and electricity pricing reform in Western Australia', *Utilities Policy*, October 2018

Key Words:

Energy, Retail Energy, Product Differentiation, Innovation, Search Costs, Strategy, Consumer Preferences

Special Session Topic:

Energy Markets