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Consumer Preference Not to Choose

Methodological and Policy Implications

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Contents

I. Introduction	1
II. Looking at the “Best” Jurisdictions	2
A. International Examples	3
B. Domestic Examples.....	7
III. Modeling Implications	13
A. Choosing Not to Choose	13
B. Possible Representations	16
IV. Policy Commentary	19
V. Conclusion.....	20
References.....	23

These reasons are amenable to conventional eco

“Retail Electricity Deregulation” Index, for April 2003 (Treadway and Malloy 2003).³ The top two are countries: Britain and New Zealand. The list also includes the Canadian province of Alberta, along with four U.S. states: Texas, Pennsylvania, Maine, and New York.

A. International Examples

England.⁴ By most comparisons, the English retail experience appears to be fairly successful, justifying its CAEM ranking of 88, substantially above that of New Zealand’s second-place 75.⁵ The main way entrants attract customers is from door-to-door sales.⁶ To help consumers choose among suppliers, compare prices, answer questions, and resolve complaints, the Department of Trade, under the Minister of Energy, has created a consumer advocacy organization, Energywatch. According to the Office of Gas and Electricity Markets (OFGEM), the British energy regulator, consumers do switch primarily for lower prices, but that they do not always choose the least expensive supplier, despite limited differentiation. As of 2004, more than half of electricity customers had switched suppliers, although some had switched back to the incumbent retail utility. Stephen Littlechild, Director General of Electricity Supply from 1989 to 1998, has attributed the success of the English experience to full separation of competitive generation from monopoly distribution and transmission, as distinguished from limited “functional unbundling”—that is, rules for separate operations that nonetheless keep these stages within the same corporation, which prevails in the United States (Littlechild 2005).

³ The “RED” index is a weighted average of 22 attributes of electricity markets applied to states, Canadian provinces, three Australian states, England, Wales, and New Zealand. The attributes pertain to facets of the retail competition institutions, generation markets, consumer protection, distribution regulation, and regulatory commissions. The factors getting the most weight are anti-favoritism safeguards, standardized business practices, generation market structure, liberalization of the wholesale market, and the limited marketplace role for regulated default service.

⁴ Information in this section is from Energywatch, “How to Change Supplier,” <http://www.energywatch.org.uk/hel>

As of April 2004, even in this best case, 60 percent of custo

savings, otherwise the site estimates monthly consumption.¹¹ It will then list the five least expensive suppliers and annual estimated costs, with separate lists depending on whether the electric company is able to control power to one's water heater.¹² The site also describes the process of switching, noting that it can take up to 29 working days, including coordinating an "event date" at which the actual or estimated meter reading is used by the old supplier to complete billing and the new supplier to commence

Alberta's Residential Consumer Worksheet

Name of energy supplier		
Contact name		
Phone number		
Energy supplier type (competitive retailer/regulated service provider)		
What is the fixed rate?		\$
What is the variable rate?		\$
What is the energy charge (per kilowatt-hour kWh) as per contract? (Get Govt. Consumer Rate for Natural Gas) \$ kWh per		
If yes, amount and when		
What are the retail service fees?		
Are there any additional charges or fees not shown on your bill? (Electricity Only)		
Pool service charge		
Distribution loss charge		
Do I have a premium for green power? (Electricity Only)		
Terms of the agreement?		
What does the clause concerning supply interrupt		
Does the price depend on the time of day?		
Does the price depend on the use of day first? (non-wire electric heating)		
What is, if any, the switching fee or other up-front charges?		
What are the exit provisions for cancelling the contract?		
Are there meter-reading fees?		
Can I buy anything other than electricity or		
Are services available to help me use electro		
Will I be informed in advance if gas supply is also being affected?		
Who do I call if I have questions or problems?		
Contact: Retailer number		
Is the place/supply tied to a specific electricity generation plant?		
What occurs in the event of an outage at that plant? (Electricity C		

This worksheet is provided as a guide only. It is not intended to be a substitute for professional advice. The user should consult with a professional advisor for more information. The user should also consult with the relevant regulatory body for more information. This worksheet is provided as a guide only. It is not intended to be a substitute for professional advice. The user should consult with a professional advisor for more information. The user should also consult with the relevant regulatory body for more information.

Figure 1: Alberta's residential consumer worksheet

However, the Alberta regulators apparently believe that many consumers are not inclined to exercise this judgment. They have recently extended the regulated retail tariff for residential, farm, and small commercial customers from Dec. 15, 2005 until July 1, 2006, and even beyond that point, Albertans will be able to remain on a default service under which they pay the wholesale market price plus the transmission and distribution tariff.

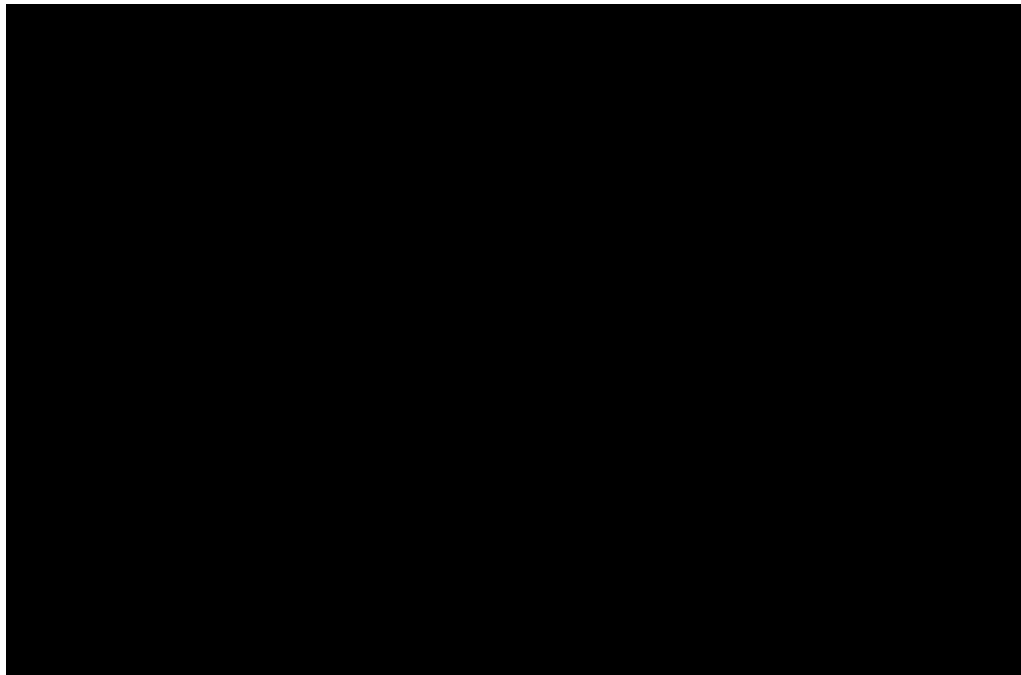


Figure 2a: Eight Steps in Shopping for an Electricity Supplier

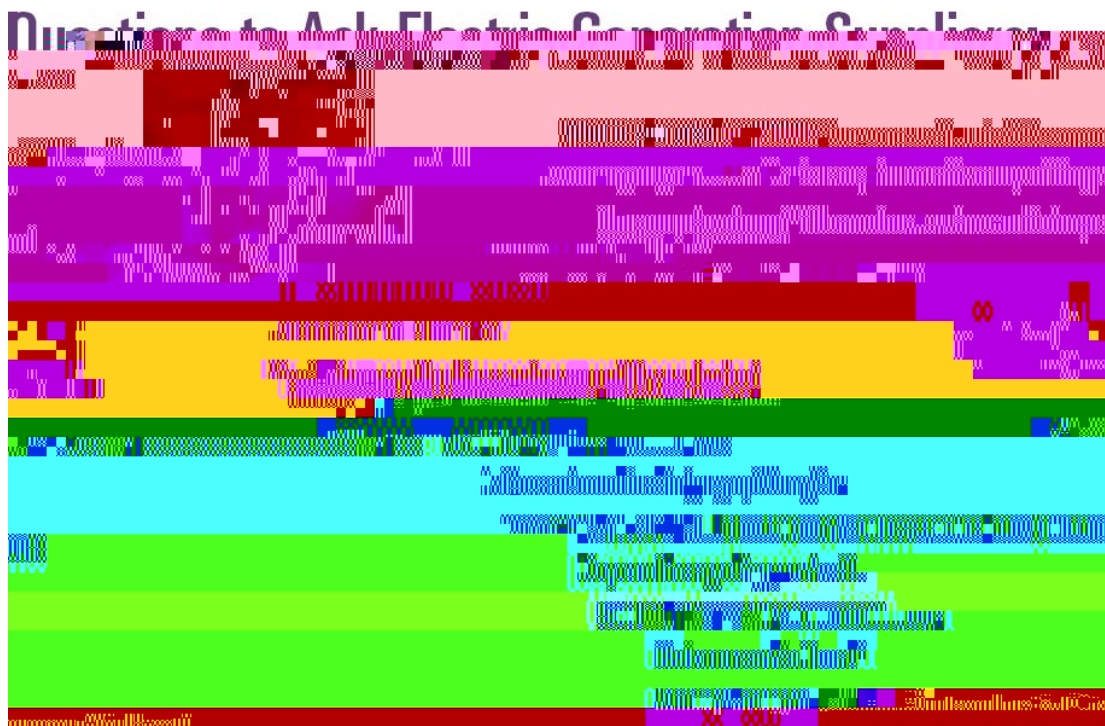


Figure 2b: Questions to Ask Each Potential Supplier

Maine. Despite scoring third-highest of all the states (64) on CAEM's index, CAEM reported very little retail switchi



Figure 3: New York’s Electricity Consumer Checklist

III. Modeling Implications

A. Choosing Not to Choose

The settings described here are among the most successful implementations of retail competition, yet their success in the residential sector is limited at best. The nature an

checklists to help consumers make price comparisons and to obtain information on terms and conditions of the contracts, and most recognize a need to offer “provider of last resort” or “default” service for consumers who refuse to ch

$$r(P_1) = [P_1 - C] \int_0^{K(P_1)} Q(\cdot, P_1) \quad , \quad (1)$$

where $K(P_1$

Welfare loss to consumers who remain with the incumbent = $\int_0^K \int_{P_R}^{P_I}$

IV. Policy Commentary

Concerns regarding the state of the retail markets go back certainly to the beginnings of the market-opening era in electricity, predating such crises as the 2000–01 market implosion in California and the August 2003 Northeast blackout. In 1998, the National Conference on State Legislatures published a report suggesting that consumer education would be necessary for low-usage customers who “may not have the time or resources to fully understand or research their options” (Brown, Eisenberg, and Hill 1998). The report noted that during a pilot retail competition program in New Hampshire, many consumers “said that they felt overwhelmed by the array of choices available to them.” The report additionally recommended simple, standardized billing. It suggested that aggregators—municipalities, churches, credit unions, or other “affinity groups” could do the researching and buying. The report took for granted that there will be a default provider to serve “customers that do not choose a new supplier.”

Even these early recommendations called into question some potential benefits of retail competition. Standardized billing can make choosing easier. Doing so, however, substantially limits the degree to which entrants can differentiate themselves through fee structures, real time pricing or rate averaging, cancellation fees, contract length, and the like. Aggregation may be useful, but in theory the formation could and is left to markets in general without regulatory mandate or encouragement, if they are cost-effective means for procuring electricity. Grocery stores, for example, might be thought of as “food aggregators,” and consumers can shop around for who does the most preferred “aggregating” along the price/quality continuum. Implicit in the advocacy for aggregation is the idea that the aggregator would become the default provider, taking over the choice role for its consumer members.

Beginning by quoting Woody Allen that “it’s a sin to buy retail,” Paul Joskow in 2000 argued that incumbent distribution companies should offer retail customers a “Basic Electricity Service” (BES) passing through ostensibly competitive wholesale energy prices (Joskow 2000). Entrants would compete by coming up with value-added services such as bundling with other utilities, green power, hedging, and energy management. If they cannot—and Joskow appears skeptical that they can—it would be inefficient for policymakers to set “shopping credits” above the wholesale price or to provide subsidies in order to encourage switching away from the BES. Steven Littlechild (2000) has disagreed, arguing that retail competition can reduce prices and provide a wider variety of hedging options. The market can provide BES if consumers want it. The debate between Joskow and Littlechild turns on whether consumers are better off given a

reasonable passive choice, or if they should exercise their preference through active supplier selection.

Around the same time Theresa Flaim, then Vice President for Strategic Planning at Niagara Mohawk, noted the lack of consumer interest in switching, even in Pennsylvania where switching was “deliberately subsidized” (Flaim 2000). She attributed this to both economics—the absence of value added service relative to the transaction costs of serving small customers, and policy conflicts—the tension between opening markets, encouraging switching, and insulating residential buyers from price volatility and price increases. She notes that “forcing” retail competition absent identifiable benefits is not worth it, in part because of real “customer search and hassle costs” (Flaim 2000, 52). For political and legal as well as economic reasons, she recommends a default service based on spot prices without hedging similar to Joskow’s BES, most likely provided by the incumbent utility; entrants can provide

electricity is “different,” but that the rapid transition to open markets would force consumers to switch when they are reluctant to do so in general. A model with costs of switching away from an incumbent indicates that net welfare effects, taking switching/search costs into account, can be negative. Those who remain with the incumbent rather than switch have to pay higher prices, and those with high costs who do switch nevertheless may have been better off with the unregulated price. Considerable commentary bears out these concerns.

Perhaps these conclusions are pessimistic, in that as states rescind “standard offer” prices enacted in the initial stages of retail restructuring, more entry and switching may be forthcoming, particularly if “provider of last resort obligations” charges incorporate a premium to reflect the risk of customer churn and nonpayment.⁴⁰ Nevertheless, the analyses above suggest some policy recommendations. A first would be to realize that much of the value of opening electricity markets will be achieved in offering choice to industrial and commercial users. The residential portion of the market in the United States comprises only about 36.4 percent of total electricity use.⁴¹ Competition for the other 63.6 percent will not only be beneficial on its own but could also lead to lower benchmark prices for residential customers. Over time, residential users might overcome reluctance to choose if it appears to be bringing benefits to other parts of the sector. But until that point, rather than lament the failure of small users to jump on the competition bandwagon, electricity market advocates might follow Senator Aiken’s advice and declare victory.

Such a declaration entails that consumers continue to be offered a default alternative. The model suggests that a primary cost of that alternative will be that a default provider would have the market power to capture the rents from consumer reluctance to choose. Consequently, for economic as well as political reasons, one may not only need to designate a default provider to avoid forcing consumers to make choices they would rather not (Sutherland 2001). That default provider may also need to have its prices regulated so that it is unable to exploit its privileged position. In the model, the closer the incumbent’s price P_1 is to the regulated price P_R , the less

⁴⁰ The model in Section III.B above indicates that switching induced by higher incumbent prices may not increase economic welfare relative to regulation.

⁴¹ Calculated from U.S. Department of Energy data on electricity use by sector for 2004, http://www.eia.doe.gov/cneaf/electricity/epm/table5_1.html, accessed Apr. 18, 2005. Colin Loxley, Director, Resource0 10.02 434.92lanning, Public9 Tc 10.02

high search—costs consumers will be harmed by opening markets.⁴² This explains why the political bargain for opening markets typically includes retail price ceilings, if not cuts. But one needs to be sure that price ceilings do not insulate consumers from facing real increases in wholesale costs to prevent a repeat of the inelastic demand and bankruptcies substantially responsible for the California 2000–01 crisis (Brennan 2001).

A last set of lessons is methodological. Economics paradigmatically assumes that choice is always preferred. This entails that consumers do not find competition inherently costly rather than transparent. The experience in electricity—and before that in telecommunications—suggests that consumers do not always regard open choice as a favor. A look at the marketing literature suggests that consumers in general have a limited propensity to reevaluate the choices of all the goods in their consumption bundle; only a few may be up for competitive grabs at any one time. If economics is to take revealed preference seriously, it should do so when the revealed preference is not to have to choose.

A policy implication is that interference with markets may be justified outside of the usual market failure categories of market power, externalities, or asymmetric information. Regulation of a franchised monopoly, or public provision, may well be justified if the gains from competition and differentia

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