Microeconomics Revision Essay (4) Market Contestability and Utilities

(a) Explain why the degree of market contestability is significant for the performance of an industry 20 marks

(b) Evaluate the effectiveness of measures taken in recent years to increase the contestability of the market for domestic gas and electricity supplies 30 marks

Define a contestable market:

A perfectly contestable market is one in which entry and exit is absolutely costless and competitive pressures supplied by the threat of entry, as well as the presence of actual current rivals, can prevent monopoly behaviour (higher prices and restricted output).

However, if entry is not easy, and there are barriers to entry, the threat of competition is less. Barriers exist when there are sunk costs, expenses that cannot be recovered once a firm has entered the industry.

The degree of contestability will have an effect on the long run structure and performance of a particular industry or market

What criteria might be used to measure the conduct and performance of an industry?

- Long term prices and output
- Allocative efficiency and productive efficiency (trend in average costs)
- Profitability of businesses within the industry (including the potential to earn supernormal profit in the long run)
- Levels of capital investment and research and investment
- Other indicators of dynamic efficiency (including quality of service, pace of innovation)

Contestable Market and Supernormal profits

In a contestable market, if the existing firms are earning economic profits, this attracts new firms to enter, thus driving profits down to a normal level. The theory of market contestability argues that the threat of this occurring, will ensure that firms already in the market will a) keep prices down so that it just makes normal profit, and b) produces as efficiently as possible taking advantage of economies of scale and new technology. If the existing firm did not do this, entry would take place and potential competition would become actual competition

Develop the answer by tracing the likely effects of an increase in market contestability - again, examiners will always reward relevant real world examples. Take industries that have become more contestable in recent years.

A good example to use on contestable markets is the parcel delivery and courier services industry. This market was deregulated in the 1980s and is now highly competitive, even though most of the market is in the hands of major national and international players. Local parcel courier businesses can operate profitably in individual towns and cities. National service
providers can exploit economies of scale and deliver parcels to increasingly tight deadlines both within the UK and overseas.

The UK parcel delivery market now shows strong competition both in price and non-price terms. The real cost of deliveries has fallen and there is widespread evidence of improvements in the reliability and quality of the service provided - illustrative of gains both in static and dynamic efficiency.

- UPS
- Parcel Force
- DHL Worldwide Express
- Amtrak Express Parcels
- APC
- FedEx
- TNT
- Deutsche Post
- Securicor (Omega)
- Ly

An increase in market contestability in an industry where existing profits are high will lead to an increase in market supply and downward pressure on market prices. This should lead to an expansion of market demand and an increase in the equilibrium quantity that the industry can provide at a given price. This is shown in the diagram below.

In reality no markets are perfectly contestable - there are always some barriers to the mobility of capital that limit the entry and exit of businesses within a market. Develop this point by identifying some of the possible economic costs arising from the exploitation of monopoly power - including the loss of allocative efficiency because prices are kept above marginal and average cost.

Intuitively, a market that is more competitive should see lower prices and a higher output than one which is dominated by a few large producers - but this depends on the cost structure of the industry - in particular the potential for existing firms to exploit internal economies of scale in the long run.
Much also depends on the objectives of businesses in the market i.e. whether we drop the neo-classical assumption that firms always seek to maximise profits in both the short and the long run.

(b) Evaluate the effectiveness of measures taken in recent years to increase the contestability of the market for domestic gas and electricity supplies

This question requires some background knowledge on what has happened to the gas and electricity supply industry in recent years - a sector where the regulatory authorities have made deliberate attempts to increase market contestability. There must be some evaluation in this second answer - most of which will probably come towards the end of the answer - but do try to include some evaluative points along the way.

Liberalising the Market

The domestic gas industry was privatised in 1986 (British Gas moved from being a state-owned monopoly to a private sector monopoly) and the electricity generating and supply industry was privatised in 1990. At the time, the privatisation created a duopoly in electricity supply (PowerGen and National Power) with regional electricity companies charged with the task of supplying power to consumers and billing them / dealing with customer enquiries / complaints etc. Both industries were subject to price capping because they remained essentially monopolies.

There were initially two regulatory agencies - OFGAS (gas) and OFFER (electricity) - who then merged to become OFGEM (a reflection of the increased integration within the industry including the expansion of dual-fuel suppliers)

The market for domestic gas supply in Britain was opened to competition in May 1998 (a process known as market liberalisation). The regulators used their statutory powers to open up the market for gas delivery and they have also created a more competitive market structure in the generation of electricity. The regulators took the view that price capping could help to limit the impact of monopoly power in both markets, but that consumers (both domestic and industrial) would benefit more in the long term if the market was opened up to genuine competition.

In the electricity generating industry, a new market trading arrangement has been established in 2000 with the creation of a new wholesale market for electricity. Now, competitive trading takes place between the power generators (PowerGen, British Energy) and main suppliers of electricity. The hope is that cost savings will be passed down to the final consumer.

Impact on Prices

Between 1986 and 1999, average gas prices have fallen in real terms, by 69 per cent for industrial consumers and also for domestic consumers.

Industrial gas prices in the UK are now the lowest in the EU and average tariffs for domestic (household) gas consumers are the third lowest within the European Union

Of the Group of Seven countries, only the US and Canada have lower domestic gas prices, indicating that countries with indigenous resources tend to have the lowest prices (a reflection of the law of comparative advantage)
Gas and electricity prices have been falling in most of the leading industrialised countries over recent years (partly lower costs of natural gas, but also because other countries have introduced greater competition into their supply industries).

By the end of 2000-2001, one in three domestic gas, and one in four domestic electricity, customers had switched their supplier. On the supply side of the market, there are now 16 gas suppliers and 13 electricity suppliers with 11 companies offering “dual fuel” contracts.

In a detailed report on the market for gas and electricity supply published in 2000, the National Audit Office Report concluded that increased competition in gas & electricity was “a major achievement” with a £750m annual fall in domestic electricity bills and a £1 billion annual decline in domestic gas bills. The number of complaints made to gas supply companies has also declined - perhaps an indication of an improvement in dynamic efficiency in the industry.

Most analysts believe that deregulation / liberalisation of the industry has been fairly successful - in April 2002, OFGEM gave up all remaining controls over the cost of electricity and gas bills. Ofgem has said the level of competition within the industry was sufficient for price controls to be lifted and that it expects the lifting of price caps will give gas and electricity companies the freedom to cut prices. The watchdog also said the number of people switching suppliers - including pre-payment customers - showed competition was working. It said 15 million customers have switched suppliers, with 170,000 changing firms each week.

However there have been problems during the transition.

A report by the House of Commons’ public accounts committee (PAC) claimed that millions of people could be paying less for their electricity bills, if the regulator made it easier for them to

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**CHANGES IN INDUSTRIAL GAS & ELECTRICITY PRICES**

[Bar chart showing changes in industrial gas and electricity prices across different countries from 1990-1999, with notable declines in Germany, US, UK, and EU.]

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switch supplier - but that high-pressure selling techniques by the energy suppliers had created confusion among consumers. By June 2000, about 19 million customers had not switched suppliers, even though, together, they could save up to £670m - about 13% of an average yearly bill. The benefits to consumers of greater competition have not been evenly spread.

It is difficult and costly for consumers to monitor the performance of all of the individual companies in the market and to make rational decisions on which supplier to choose - there are fears that suppliers are not using a standard approach to pricing and that miss-selling of supply contracts is now rife and harms certain vulnerable groups of consumers in particular.