

Opening the Retail Electricity Markets: Puzzles, Drawbacks and Policy Options

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Abstract

The Italian electricity retail market is fully liberalized since 2007, allowing all households to choose between a regulated tariff and those offered in the free market. However, as of 2016, almost 70% of households remain with the regulated contract and only 4.5% moves every year to the free market. Moreover, contracts more costly than the regulated default one are offered and subscribed. In this paper we first analyze the best and worst offers on the free market, identifying significant potential gains but also losses when switching from the regulated tariff to the free market. Then we build up a sequential search model that extends Janssen et al. (2005) to explain this evidence. Consumers have zero (shoppers) and positive (non-shoppers) search costs. These latter receive upward (pessimistic) or downward (optimistic) biased signals of their current regulated price. We obtain a rich set of mixed strategy equilibria with different level of participation of non-shoppers of either type, price dispersion and some contracts more costly than the regulated one. Equilibria with a larger participation of non-shoppers are associated with higher expected and minimum prices. Search costs and perception bias are key parameters in comparative statics, with policy implications to improve market performance. Finally, by mid 2019 the Government has planned to lift the regulated tariff. We use the model to predict possible outcomes including an initial increase in prices.

Keywords: Search costs, liberalized retail markets, price dispersion, gains and losses from switching

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