Price gouging by electricity companies: may be legal, but is it fair?
2nd June NZ Herald

Ananish Chaudhuri

I am somewhat bemused by the recent hue and cry about price gouging by our electricity companies. After all, the companies have done exactly what we teach students in our economics principles courses; charge high prices when demand is high, a policy commensurate with profit maximizing, which is at the core of market based economies. After all, no one is accusing these firms of doing anything illegal. In cases like this there is always the possibility of implicit collusion among the companies involved, but at this point there seems to be no evidence to support this conjecture. (The National government's outrage in the matter appears rather disingenuous, given their decision to fire Paula Rebstock, who, by all accounts, was doing an excellent job of combating such practices during her tenure at the Commerce Commission.)

Furthermore, on the face of it, what the electricity companies were doing is no different from the pricing practices of others. Try buying tickets on Air New Zealand during the school holidays or check out the fare differences in flights at peak and off-peak times and you will know what I am talking about. No one, as far as I can make out is making similar accusations against Air New Zealand. One could argue that price gouging in electricity markets is of greater concern given that heat and electricity are necessities in life. Airline travel is more of a luxury. (Though if you live on one of two tiny islands in the middle of the South Pacific, then your transport choices are often rather limited.)

But what the outrage over electricity prices shows is that beyond profit maximization and market economics, people care deeply about fundamental fairness and companies that contravene those fairness norms do so at their own peril.

Firms that have some degree of monopoly power often exploit that power to increase profits by charging different customers different prices depending on their willingness to pay a higher price. What the seller is trying to achieve in such cases is to get from each customer the most that the latter is willing to pay for the good.

A group of American researchers including the 2002 Economics Nobel laureate Daniel Kahnemann have used extensive questionnaires to understand people's predispositions towards a multitude of pricing strategies adopted by businesses. Here is an example that is particularly relevant in the current context: *"A hardware store has been selling snow shovels for $15. The morning after a large snowstorm, the store raises the price to $20."* Respondents were asked to rate this move as (1) completely fair; (2) acceptable; (3) unfair and (4) very unfair. Out of 107 respondents, 82% considered this unfair or very unfair.

Many forms of price discrimination were considered outrageous by the survey respondents. Consider the following question: *"A landlord rents out a small house. When the lease is due for renewal, the landlord learns that the tenant has taken a job very close to the house and is therefore unlikely to move. The landlord raises the rent $40 per month more than he was planning to do"*. Out of 157 respondents only 9%

thought this was acceptable while a whopping 91% considered this unfair. On a different question, a majority of respondents thought it unfair for a popular restaurant to impose a $5 surcharge for Saturday night reservations.

The near unanimity of these responses suggests that pricing strategies that deliberately exploit the vulnerability of a particular individual is considered offensive by most. These findings illustrate the role that norms of fairness play in day to day pricing decisions and how these norms can and do serve as a constraint on unfettered profit-making.

The survey responses suggest that many actions that are both profitable in the short run and not obviously dishonest are likely to be perceived as unfair exploitations of market power. Now one might be tempted to discount some of these conclusions by arguing that these are, after all, responses to hypothetical questions. A particular respondent might say that he will not patronise a firm that is engaging in price-gouging by jacking up the price of an essential commodity in an emergency but when push comes to shove the buyer might easily give in. The problem here is that it is very hard to show that people are not buying something in protest since it is impossible to prove a negative.

But recently economists have used economic decision making experiments with relatively large amounts of money at stake, to show that indeed *"demand withholding"* by buyers - where the buyers essentially refuse to buy at prices considered unfair and discriminatory - can be a significant factor in market interactions. Such demand withholding is especially pronounced when the sellers are significantly better off at the expense of the buyers and especially when the buyers are made aware of this inequitable distribution of the benefits by providing them with information about the profits accruing to each party.

In the backdrop of the current recession, where households are really feeling the pinch, what the electricity companies have done may not be illegal, but by exploiting consumer vulnerability, they have contravened fundamental notions of fairness that many of us hold dear. And for that, I expect, they will pay a price. We will have to wait and see what that price is.

Ananish Chaudhuri is an associate professor of economics at the University of Auckland and the author of "Experiments in Economics: Playing Fair with Money". He often blogs on http://www.thesecondgroove.blogspot.com.