Ofgem and the Philosopher's Stone

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"The philosopher's stone is a legendary alchemical substance said to be capable of turning base metals into gold.… Efforts to discover the philosopher's stone were known as the Magnum Opus, 'The Great Work'." (Wikipedia)

For the last few years, Ofgem's Magnum Opus has been the search for the philosopher's stone that will turn base retail markets into gold. Its first attempt was the non-discrimination licence condition known as SLC25A. Ofgem recently discontinued this. After three years, the condition has reduced rather than increased retail competition. Ofgem's second attempt was the Procrustean Bed that would require all suppliers to have a single standard variable tariff per payment method, with a uniform monthly standing charge to be set by Ofgem itself. Ofgem abandoned this proposal before implementing it, having "listened carefully to the concerns raised by consumer groups and other stakeholders [and] also uncovered practical difficulties". (*Retail Market Review - Updated domestic proposals* p 9) Its third attempt is its *Updated domestic proposal*, to restrict all energy suppliers to a maximum of four tariffs per fuel.

It is alarming to read (*The Times*, Friday Nov 2 2012) that the Government is now intending to enact into law a mechanism that would simplify the number of energy tariffs on offer. There are also various political proposals that suppliers should be required to put vulnerable customers on their best tariffs – or, in one version, should be required to put *all* their customers on their best tariffs. These ideas appear to reflect the same alchemical thinking that lies behind Ofgem's Magnum Opus.

An elementary economic fallacy

All these proposals are based on an elementary economic fallacy: the assumption that the range of tariffs available in a competitive market would remain unchanged if new obligations of the kinds proposed were introduced. Patently they would not. If a supplier were required to put all its customers on its best tariff, it would withdraw that "best" tariff quicker than a politician could say "philosopher's stone".

To illustrate, *The Times* article suggested that the average annual dual fuel bill is about £1300 and the cheapest dual fuel tariff is about £1165, a difference of about £135. It said that roughly 75 per cent of customers are on standard tariffs and 25 per cent on cheaper ones. Consider a major supplier with 3m customers on standard tariffs and 1m customers on cheaper ones. Which would be more profitable: to cut prices by £135 to 3m customers, at a loss of revenue of £405m per year, or to withdraw the cheap tariffs and lose 1m customers that were of only borderline profitability? This is a no-brainer.

Would it be viable to put only specified vulnerable customers on the cheapest tariff? At first, this sounds more reasonable. Suppose customers aged over 75 years account for only 5 per cent of the supplier's 4m customers. Yet the supplier's loss of revenue from putting all of them on the cheapest tariff would still be £27m. It would still make more economic sense for the supplier to give up its barely profitable low price customers than to continue to compete.

Such proposals are effectively a tax on competition. They would drive the major suppliers out of the competitive market, along with their lowest prices. Active customers would be worse off without making vulnerable customers better off. But worse: over time this reduction in competitive pressure would increase prices and profit margins across the board. Then *all* customers would be worse off, including the vulnerable ones.

Ofgem's non-discrimination condition

The same fallacy underlay Ofgem's non-discrimination condition. In 2009, Ofgem expressed concern that incumbent suppliers were charging higher prices to their less active "in-area" customers - that is, customers in the areas where the supplier was the monopoly supplier before the market opened to competition - than to their more active "out-of-area" customers. To secure the lower prices for the less active in-area customers, Ofgem prohibited such price differentials for three years.

There is now evidence from Ofgem's publications to show the adverse effect this has had. The major suppliers did indeed equalise their prices, as required - but as might have been expected they did not do so by lowering their in-area prices. They raised their out-of-area prices. Active out-of-area customers were worse off, but inactive in-area customers did not benefit. Indeed, they seem to be worse off, insofar as the average retail profit margin – as calculated by Ofgem – has increased since 2009. Only the major suppliers were better off.

Market segmentation

Ofgem's Four Tariff proposal is part of its campaign to prevent suppliers splitting potential customers into different groups – so-called segmenting the market. "Not only does this [segmentation] mean that some consumers pay significantly more than others, but it also further weakens competitive pressures by advantaging the previous incumbent supplier". (*Updated domestic proposals* p 66)

This argument exhibits the same fallacy. Today's major suppliers already have any such advantage from being incumbents. If competition meant they were forced to lower their prices to all their existing customers it would be more profitable not to compete. Segmenting the market enables these suppliers to challenge each other in ways that would not be possible if suppliers were restricted in the number of their tariffs. Market segmentation increases, not decreases, competitive pressures. Preventing market segmentation – as with the non-discrimination condition - would remove the lower price offers and leave the higher ones unchallenged. And once unchallenged, the higher prices are likely to increase.

The campaign against market segmentation also sits oddly with Ofgem's campaign for "personalised market best deal information". Suppliers are to be required to give customers personalised information as to what is the best deal for their own particular circumstances. But they are not to be allowed to tailor a personalised offer to these particular circumstances.

Ofgem's Four Tariff proposal

Ofgem now proposes that each supplier should be allowed only four tariffs. On the surface, this sounds more moderate than its Procrustean Bed proposal, which allowed only one tariff per payment method. However, that proposal applied only to standard variable tariffs: the new proposal applies to *all* tariffs. This is particularly repressive. It prevents the kind of competition in fixed-price fixed-term contracts and temporary offers that was able to develop despite Ofgem's non-discrimination condition. Even 'white label' products provided for supermarkets are counted within the limit of four.

A multitude of additional restrictions are now proposed. For example, suppliers can only offer discounts for online or dual fuel purchases if they offer the same discounts on all tariffs, and expressed in pounds rather than percentages. But a discount that might be economic to offer to a large customer might be uneconomic to offer to a small one. If forced to set the same discount to all customers, a supplier might well find it more profitable to reduce or withdraw the discount.

Multi-tier tariffs are to be prohibited. This will not prevent a supplier from offering a tariff with zero standing charge. But if the supplier can no longer reduce its unit charge once it has recovered its fixed costs, this means that the tariff will increase prices to small-to-medium customers who might prefer no standing charge.

Customers on 'evergreen' tariffs (with no fixed termination date) that are no longer open to new customers must be migrated to the cheapest live evergreen tariff. But if closing one tariff means that all existing customers have to be transferred to another cheaper tariff, this will lead suppliers not to close the first tariff and perhaps not to introduce the other one. Again the same fallacy.

Thus, the immediate consequence of implementing Ofgem's or related proposals would be that many tariff options and discounts that customers presently value would be reduced, withdrawn or prohibited. The more active customers would immediately be worse off, while the less active customers would be no better off and some would be worse off. But before too long, *all* customers would be worse off, as competition diminished. Again, this seems to be happening. Under pressure from Ofgem, some of the major suppliers have already reduced the number of their tariffs. This limits their ability to compete with each other. And retail profit margins are continuing to rise.

What is Ofgem's justification?

Ofgem explictly acknowledges many of the downsides of restricting suppliers' options and limiting customer choice. Its repeated rationale is that, paradoxically, in the longer term, these restrictions will increase competition.

Ofgem's chain of reasoning has four critical elements: there is now too little customer switching in the retail market; tariff complexity is what is preventing more customer switching; tariff restrictions such as Ofgem proposes will so simplify the situation as to promote significantly greater customer engagement in the market; and this in turn will encourage energy suppliers to compete more effectively.

There is no reason to believe any one of these propositions, let alone all four. Despite the recent decline in switching, the British retail market is more active than almost any retail market in the world. The decline in switching was a predictable consequence of Ofgem's discouragement of doorstep selling and of its non-discrimination condition. The increased tariff complexity was a consequence of Ofgem's policy, as suppliers sought to compete despite it. The innovative tariffs are likely to have increased rather than reduced customer switching.

Whether or not customers find energy tariffs complex, documenting their grumbling about it provides no credible reason to believe that the proposed tariff simplification would promote greater engagement. It is not obvious that Ofgem's proposals would be perceived by customers as simplifying the situation – with four tariffs times 13 present suppliers they would still have over 50 different tariffs to worry about. And Ofgem's evidence that complexity is significantly hindering switching is questionable. Of those customers that chose not to switch in 2011, no less than 78% gave as their principal reason, "I'm happy with my current supplier(s)".[1] 22% said, "Switching is a hassle". *None* of the customers in that survey are reported as saying that complexity of tariffs was a reason for not switching. Ofgem's proposals would not address the reported reasons for not switching.

At issue here is the ability to understand customer behaviour. Who is likely to be best placed to do so? The whole retail energy sector has spent some 15 years in active competition to devise methods of attracting the interest of customers and persuading them to switch. A dozen switching sites have specialised in the collection, analysis and presentation of information most relevant to customers. The survival of all these businesses depends upon their ability to predict how customers actually behave. Ofgem has now spent a few months on the issue, having "sought input from expert advisers on linguistics, semiotics and information design". (*Updated domestic proposals* 3.28) It reports that only 6 per cent of its customer survey respondents said they would probably choose a variable price tariff: in reality about 75 per cent do.

Ofgem's analysis and proposals are just more alchemy. Ofgem has not found the philosopher's stone that has somehow eluded others. Its chain of argument is simply a delusion. Neither its proposals, nor others like them, will transform customers or turn the retail market into gold.

The consequences of this policy

As explained, the proposals would severely restrict retail competition with no counterbalancing advantages. The consequence of less competition would be a general increase in prices and profit margins – as indeed has already been the case

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[1] Ipsos Mori, *Customer Engagement with the Energy Market – Tracking Survey 2012*, A report prepared for Ofgem, 12 April 2012, pp 7, 22.

since Ofgem introduced its first alchemical experiment three years ago. In other words, *all* customers would be worse off, *including those vulnerable and less active customers that these proposals are particularly intended to protect*. The only potential beneficiaries would be the major energy suppliers, who would be able to enjoy quieter and more profitable lives unhindered by retail competition.

Ofgem recognises that there would be scope for "coordinated effects" but claims that a more engaged consumer base would help to reduce these effects. It does not seem to recognise just how far its proposals would go to promoting such coordination. Any group of firms wishing to limit competition faces a number of fundamental problems that normally render such coordination impractical. These include the illegality of the coordination, the unwillingness of all companies in the industry to agree, the difficulty of agreeing on the restrictive measures to be taken, the challenge of prescribing those measures in detail, the likelihood of cheating, hence the need for independent monitoring and enforcement, the problem of non-compliance by new entrants not party to the initial agreement, and so on. With remarkable diligence, Ofgem has anticipated all those problems and proposed measures to deal with them.

There would be other consequences. These proposals would considerably increase the cost of regulation - though Ofgem has admitted that it does not know what this cost would be. Ofgem's argument for change runs to 700 pages. The proposed *additional* licence conditions alone run to 80 pages. In terms of UK red-tape regulatory bureaucracy, this is the biggest step backwards in thirty years. Disputes over interpretation would be rife. Ofgem has admitted that it would need more staff to monitor and enforce these provisions.

Restrictions on the number and type of tariffs would effectively preclude innovation. A supplier could only introduce a new tariff if it withdrew one of its four existing ones. What sane company would sacrifice about a quarter of its sales to bet on an uncertain and unfamiliar product? New entrants would suffer too, insofar as they would be prevented from offering a wide range of niche products to compete with the high-volume incumbent suppliers. The policy would hinder, rather than facilitate, the evolution of smart metering, the customer skills and attitudes that this technology will call for, and the benefits associated with it. Ofgem's provisions for exceptions and derogations invite lobbying, political influence and worse.

The longer term consequences are even more serious. When such policies deliver less competition rather than more, and higher prices rather than lower, as would inevitably be the case if they were implemented, is it likely that Ofgem and the Government will acknowledge that the policies were entirely misconceived, and repeal them? More likely, it will be said that the policies did not go far enough.

There will be a demand for direct controls on profit margins, on energy purchasing policies, on wholesale transfer prices and on final retail prices. And if a competitive market has failed so comprehensively, what then is the case for continued private ownership? And without competition and private ownership, who is going to have the ability and incentive to purchase efficiently in the wholesale energy market? And is the taxpayer ready to fund the £200bn future energy investment programme that the Government envisages?

What should be done?

There are strong and understandable concerns about high and rising energy prices nowadays. But competition or the alleged lack of it in the retail energy market is not the source of the problem, other than the adverse effects of Ofgem's retail policy. The sources of the cost and price increases lie in the international wholesale gas markets, in the costs of renewables and low-carbon products, environmental regulation and other government and EU policies, and in the costs of transmission and distribution network reinforcement and smart metering. These costs need to be explicitly explained and discussed.

Energy markets are increasingly complex nowadays. But so are all retail markets, as a walk through any supermarket or retail park, or a ten minute browse on the internet, will immediately reveal. This is not a cause or consequence of inadequate competition or customer engagement. It is a consequence of increasingly sophisticated technology and marketing techniques, increasingly sophisticated customers and increasingly effective competition.

A competitive market provides different products to appeal to different customers. Products only emerge and survive if suppliers can cut through all the complexity and noise and make a case for them in a way that is sufficiently understandable to attract and keep customers. Customers are therefore better served by encouraging suppliers to experiment with more new products rather than by restricting them. Finding acceptable ways of sharing the risks of future energy cost movements between customers and suppliers is increasingly important, so different kinds of price guarantees need exploring. Maximising rather than minimising the number of fronts on which the major suppliers are subject to challenge will maximise the effectiveness of competition, and thereby maximise the protection of customers.

How to protect inactive customers? The low prices for more active customers in the market provide a significant check on what suppliers can charge for less active customers. Ofgem's figures show that competition has ensured that the standard tariff is within some 10 to 15 per cent of the very best price in the market. In terms of customer protection, this stands comparison with any other market.

The needs of vulnerable customers are particularly important. But surely these needs are not best addressed by simply requiring everyone to pay the same price, regardless of whether that price is higher than vulnerable customers used to pay before? The needs of vulnerable customers are better addressed directly than by distorting and restricting the whole of the market.

Proposals for local authorities and third sector organisations to facilitate collective switching deserve encouragement. Rather than secure better deals than the market presently offers, their main role may be to encourage customer confidence in the switching process. Measures could therefore be explored to facilitate individual switching by vulnerable customers. Such policies would work with the grain of the competitive market rather than against it. And they would not rely upon alchemy.