

## **Protecting customers or suppliers?**

### **A response to Ofgem's consultation on its Retail Market Review – Updated domestic proposals**

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#### **Executive Summary**

1. There are concerns that the complexity of the retail energy market prevents many customers from receiving the full benefits of competition. The Labour Party and the Prime Minister have suggested that suppliers should put vulnerable customers – or even all customers - on their best tariffs. Ofgem and DECC propose to simplify the market by limiting suppliers to only four tariffs per fuel, and by banning many of the competitive offers available today.

#### **I The proposals to simplify the retail energy market would increase prices**

2. These proposals are well-meaning, but they fail to look at the implications for energy prices. They would lead to the withdrawal of the best prices and other offers and discounts. They would squeeze out tariffs with no standing charges. They would effectively prevent innovation. This would reduce competitive pressure on other prices.
3. The simpler tariff proposals would encourage “coordinated effects” by suppliers. Because they inhibit the price reductions that attract customers, the proposals would reduce rather than increase customer engagement and switching. This reduction in competition would lead to further increases in prices and retail profits. All customers would be worse off, including those whom it is particularly intended to help.

#### **II Ofgem has been here before**

4. In 2008 Ofgem was concerned that suppliers were offering lower tariffs to gain customers outside their previous monopoly areas, and charging higher tariffs to their existing in-area customers who were in general less active in the market. In order to secure lower in-area prices, in 2009 Ofgem introduced a non-discrimination condition to require that passive in-area customers were not charged more than active out-of-area customers.
5. The policy failed: instead of lowering in-area prices, suppliers responded to the condition by increasing out-of-area prices. Retail profit margins increased.
6. Ofgem promised a review of the impact of the licence condition. It failed to do so. Ofgem's own figures show that the reduction in competition caused by its non-discrimination condition has been associated with increased net retail profit margins of nearly £2bn per year over the three years 2010-2012. This was at the expense of customers.

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7. During 2012, most of the major suppliers responded to Ofgem's call for simpler tariffs. This can be expected to increase prices and profits. Ofgem's projections already suggest that suppliers' net retail margins will increase by a further £1bn in 2013.
8. This makes a total of some £10bn that Ofgem's restrictions on retail competition seem to have transferred from customers to suppliers since 2007. Perhaps there are more accurate calculations or better explanations. Ofgem has not provided any. Nor indeed has it even investigated this. Yet if the Ofgem/DECC restrictions on prices were put into effect, one might expect further and greater increases in prices and retail profits at the expense of customers.

### **III The way forward**

9. To address the concern about passive or vulnerable customers, the focus should be on assisting such customers to take advantage of the competitive market. It might be possible to provide more appropriate information, as suggested by Ofgem. DECC's suggestion to facilitate collective switching and providing advice on individual switching deserves further consideration. The aim should be to work with the competitive market, not to sabotage it.

## 1. Introduction

After studying the retail energy market for several years, Ofgem has come to the conclusion that the main problem is not the structure of the market or even the conduct of the suppliers, but the limitations of energy customers themselves. The aim of its Retail Market Review (RMR) is “to encourage and equip consumers to engage effectively in the market”.<sup>2</sup>

To this end, Ofgem proposes a package of measures that “require suppliers to provide consumers with simpler choices; clearer information about products, prices and available savings; and fairer treatment in all their interactions with them”. (p 8)

Others have proposed that suppliers be required to switch particular customers from one tariff to another. The Labour Party has proposed that energy companies should be required to put all over-75s on their cheapest tariff.<sup>3</sup> The Prime Minister has said that “we will be legislating so that energy companies have to give the lowest tariff to their customers”.<sup>4</sup> The meaning of this remains obscure.

The Department for Energy and Climate Change (DECC) has endorsed Ofgem’s proposals, proposes to legislate them into effect, and in some respects goes further than Ofgem.<sup>5</sup> It also explores possibilities along the lines of the Prime Minister’s suggestion, and considers additional measures to protect consumers and promote customer engagement.

This paper examines these various possible approaches. The aim is not to challenge the perception that the retail energy market is complex – evidently it is, although most other markets are complex too. Rather the aim is to consider the consequences, and hence the suitability or otherwise, of the different proposed remedies for this.

The general point I seek to make is that those policies that seek to protect customers by restricting or distorting competition in the market will have unintended consequences: they will make customers worse off rather than better off. They will also make energy suppliers more profitable. In contrast, there are other policies that seek to enable customers to take better advantage of the competitive market. They are not without difficulties, but some of them have greater prospect of being helpful to customers.

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<sup>2</sup> Ofgem, Retail Market Review (RMR) – Updated domestic proposals, Consultation, Reference 135/12, 26 October 2012, p 7.

<sup>3</sup> Labour’s Policy Review, *Real Energy Market Reform*, 24 October 2012.

<sup>4</sup> Hansard, answer to Q3 [122162] 17 October 2012, column 316.

<sup>5</sup> Ensuring a better deal for energy customers, DECC Discussion Document, URN:12D/437, 20 November 2012.

# **I The proposals to simplify the retail energy market would increase prices**

## **2. Putting customers on the best tariff**

Proposals to require suppliers to put some or all customers on their best tariff are based on an elementary economic fallacy: the assumption that the range of tariffs available in a competitive market – or at least the “best” tariffs in that range - would remain unchanged if new obligations of the kinds proposed were introduced. Patently they would not. For example, if a supplier were required to put all its customers on its lowest-price tariff, it would probably find it more profitable simply to withdraw that “best” tariff’.

To illustrate, it has been suggested<sup>6</sup> 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 is also 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? Consider the proposal to require energy companies to put all over-75s on their cheapest tariff.<sup>7</sup> At first, this sounds more reasonable. And it is claimed that this “could save as many as four million pensioners as much as £200 a year from their annual energy bills”. Where those figures come from is not explained. But let us do the calculations using the figures from *The Times*.

Suppose customers aged over 75 account for 5 per cent of a supplier’s 4m customers. Then on the assumed tariff figures, the supplier’s loss of revenue from transferring all of them from its standard tariff to its cheapest tariff would be  $0.05 \times 4m \times £135 = £27m$ . In other words, continuing to compete for the barely profitable low-price customers will cost the supplier £27m. It would still seem to make more economic sense for the supplier to avoid this cost by withdrawing from competition and limiting itself to supplying the 3m customers on its standard tariff.

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 caused by the absence of the low-price offers would allow increases in standard tariffs. And increases in retail profit margins. Then *all* customers would be worse off, including the vulnerable ones. But the suppliers would benefit.

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<sup>6</sup> *The Times*, Friday Nov 2 2012.

<sup>7</sup> Labour’s Policy Review, *Real Energy Market Reform*, 24 October 2012.

### **3. Ofgem/DECC proposals to simplify tariffs**

Ofgem proposes to limit each supplier to four tariffs per fuel and per payment type; to “put an end to complicated multi-tier tariffs”; to prohibit “dead tariffs”; and to standardise or prohibit a range of other discounts and tariff options. DECC goes further: it proposes to specify the nature of two of these four allowed tariffs.

On the surface, Ofgem’s present proposal sounds more moderate than its previous proposal, which allowed only one tariff per payment method.<sup>8</sup> 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 after Ofgem imposed its non-discrimination condition (see below). 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.

### **4. Multi-tier tariffs and tariffs with no standing charge**

The Ofgem proposal is likely to mean the end of tariffs with no standing charge. This will be very unpopular: I well recall the demand for such tariffs from many older customers who resented having to pay a standing charge even if they used little or no electricity. Indeed, the Select Committee has recently recommended that Ofgem might need to consider allowing *only* tariffs with no standing charge.<sup>9</sup>

The new proposals will not actually prohibit a supplier from offering a tariff with zero standing charge. But the initial per unit charge on such tariffs has to be higher in order to recover the supplier’s fixed costs. At present, a supplier can reduce its unit charge for higher levels of consumption, once it has recovered its fixed costs. This maintains the tariff’s attractiveness to small-to-medium customers, and thereby maintains the tariff’s viability.

Under Ofgem’s proposals, multi-tier tariffs are to be prohibited. This means that a supplier is no longer allowed to reduce its unit charge once consumption exceeds a specified level. This means that the tariff with no standing charge will have to embody higher prices to customers above this level. Even though they might prefer a tariff with no standing charge, these customers will gradually shift to other, cheaper, tariffs. Tariffs with no standing charge will become unviable.

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<sup>8</sup> Ofgem, The retail market review – domestic proposals, 1 December 2011. For my critique of that previous proposal, see Stephen Littlechild, “Ofgem’s Procrustean Bed”, *Oxera Agenda*, February 2012, 1-5.

<sup>9</sup> Select Committee on Energy and Climate Change - Fifth Report, Consumer Engagement with Energy Markets, 18 December 2012.

One might ask: is it not possible to design a viable tariff with no standing charge that is not multi-tier? I suspect that it might be. If suppliers were not limited in the number of tariffs they could offer then they would certainly consider this. However, with only four tariffs available, a tariff with zero standing charge is unlikely to be as profitable as other more popular options. It will get squeezed out.

## **5. Dead tariffs**

Ofgem proposes that customers on 'evergreen' tariffs (those with no fixed termination date) that are no longer open to new customers (so-called dead tariffs) must be migrated to the cheapest live evergreen tariff. This may sound like sensible tidying up, and in the process giving customers on dead tariffs a better deal.

But wait. If closing a tariff to new customers (rendering it dead) means that all existing customers on this tariff have to be transferred to another cheaper tariff, this will simply lead suppliers not to close that tariff. And if they are not allowed to keep the higher price and the lower price tariffs running in parallel, perhaps it would be more profitable not to introduce the cheaper tariff. Or to delay offering a lower price tariff as long as possible. Thus, in an attempt to protect some customers, the restriction makes other customers worse off.

Again, there is the same fallacy as with the requirement to put customers on the best tariff. Requirements to switch customers between tariffs will change the tariffs that are available in the first place, and in general remove the better offers.

## **6. Innovation and smart metering**

Ofgem and DECC have emphasised the importance of innovation. Yet the proposed restrictions on the number and type of tariffs would effectively preclude innovation. New products are costly and risky, and likely to have a small and uncertain market initially. Like companies in general, suppliers are better able to bear the costs and risks of introducing new products if they do so on a small scale alongside their established high-volume product lines.

But now it is proposed that 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?

Ofgem and DECC have emphasised the advantages and importance of smart metering. A very expensive programme of equipping all customers with smart meters is already underway. These meters will allow – indeed, require – suppliers to provide customers with much more detailed and complex information than at present. It is explicitly envisaged that suppliers will offer a much broader range of tariffs, some quite different from those available in the market today. This in turn will encourage customers to use energy differently, in more efficient and environmentally sensitive ways.

The proposed policy of limiting the number of tariffs would hinder, rather than facilitate, the evolution of smart metering. It would dull rather than develop the

customer skills and attitudes that this technology will call for. It would reduce, if not outweigh, the hoped-for benefits associated with smart metering.

Ofgem has indicated that it will consider applications for exceptions and derogations. This is a dangerous way to try to encourage innovation. It will invite lobbying, political influence and worse. It will lead to allegations of favouritism, placing Ofgem at the centre of controversy.

## **7. Impact on small suppliers**

If the Big Six suppliers are constrained by the new proposals, will that nonetheless advantage the smaller independent suppliers, so that competition might in fact increase rather than decrease?

In some respects smaller suppliers could benefit – for example, the reduction in competition would lead to a general increase in tariffs, which would assist them. The four tariff restriction means that the big suppliers would no longer be able to offer niche products of interest to small numbers of customers. Green energy would be a prime example. This might not sound a sensible policy from the environmental perspective, but smaller suppliers specialising in green energy could benefit.

However, the four tariff rule would apply to all suppliers, small as well as large. This means that new entrants would be prevented from offering a wide range of niche products to compete with the high-volume incumbent suppliers. And if they wanted to extend beyond a small range of niche products to attract more customers, they would have to give up their niche products.

The costs of complying with Ofgem's proposals – in terms of changes to IT systems – would also be heavy. Set-up costs of new IT in the millions of pounds are being mentioned. This would weigh more heavily on smaller suppliers than on larger ones.

Ofgem too would incur substantial costs. Its earlier consultation documents spelled this out. It makes reference to this “very substantial project” in its latest Forward Work Programme.<sup>10</sup> These costs would be included in higher licence fees to suppliers which in turn would be passed on to customers.

Small suppliers and new entrants make an important contribution to the energy market, not only in terms of price but also in terms of innovation and customer service. At present, suppliers below a specified size are exempt from certain obligations. Estimates of the cost of this range from £60 to £90 per customer per year. As retail margins have increased, more small suppliers have entered the market. It is to be hoped that they continue to enter and grow. But to date, small suppliers even in aggregate have not accounted for more than about 1 per cent of the domestic energy market. Even if small suppliers manage to grow faster than ever, despite the restrictions that the proposed policy will put on them, it cannot be argued that they

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<sup>10</sup> “As described in this Forward Work Programme, there are some very substantial projects planned for 2013-14. These include a major programme of work to implement our Retail Market Review (RMR) proposals for a package of simpler, clearer and fairer measures to improve the competitiveness of the retail market.....” Ofgem, Forward Work Programme FY2013-14, Reference 166/12 18 Dec 2012, p 16

will offset the adverse effects of the Ofgem/DECC restrictions on competition in the market as a whole.

## 8. Price reductions or price increases?

Ofgem's focus is on enabling consumers to engage effectively in the market. All its criteria for assessing its policy are geared to that end.

“Within the overall aim of improving customer engagement, we are looking to achieve three objectives with our proposal:

- make the market simpler ...
- make the market clearer ...
- make the market fairer ....”<sup>11</sup>

The Summary of impacts on consumers has seven measures: supplier cheapest deal, Tariff Comparison Rate, tariff simplification, clearer and simpler information, Standards of Conduct, protecting consumers on fixed term offers, and market cheapest deal. Ofgem evaluates these proposals against four criteria: Aware of alternatives, access market information, assess alternative offers, confidence and incentives to act.<sup>12</sup> The Summary finds that the proposals will have either neutral or positive impacts on all criteria.

However, this assessment generally takes as given the tariffs, discounts and other options that are available in the market. It does not ask what impact the proposals might have on the availability of such tariffs. Surprisingly, given the importance of energy prices to most customers, Ofgem does not ask what the impact of the policies might be on prices. It seems not to be interested in this. In fact, out of 700 pages of documentation of its proposals, only four paragraphs – less than one page – are devoted to a discussion of the impact on prices.

Ofgem does not claim that its proposed policy will reduce prices to customers. It only raises this issue in order to address the possibility that its proposals might increase prices. Its response to these concerns does not provide much reassurance.

It acknowledges two possible reasons why prices might increase.

“We recognise that there is scope for “coordinated effects”. Firstly, with fewer tariffs in the market coupled with the TCR [Tariff Comparison Rate] and other simplification measures, suppliers may find it easier to monitor each other's prices and/or bundled products and services. Over time, it might be that this greater transparency allows suppliers to respond more easily to rivals' strategies, thereby reducing the differentials that exist between them.

Secondly, it is possible that suppliers remove their cheapest deals from the market if our proposal result(sic) in raising the prominence of those deals. Suppliers may decide that there is too great a risk of consumers moving to the cheapest deal in high numbers and reducing their ability to maximise revenues and profits.

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<sup>11</sup> Ofgem, Draft Impact Assessment, para 2.1, p 13.

<sup>12</sup> Ofgem Draft Impact Assessment Figure 1 p 12.

We recognise the possibility that our proposal could lead to a short-term reduction in the availability of deeply discounted deals.”<sup>13</sup>

These are indeed the arguments that have been made above. “Recognising the scope” for closer price differentials and “recognising the possibility” of the lowest prices being withdrawn are about as close at a regulator normally gets to admitting that its policy will in fact lead to price increases.

So what reasons are given why this will not be the case?

### **9. Deterring or promoting coordinated effects?**

Ofgem says that there are already coordinated effects in the market.<sup>14</sup> It continues “on balance, we consider that a more engaged consumer base will help to reduce these effects and will outweigh any incentive for firms to coordinate their actions”.

Suppose for the moment that the policy proposals did indeed lead to a more engaged consumer base (though I argue shortly that they won’t). How will this outweigh any incentive for firms to coordinate their actions? Ofgem’s explanation is that “a more engaged consumer base, one which is better able to assess tariff options, will look to see where the best deal lies across the supplier spectrum”. (para 4.10)

However, Ofgem seems not to realise just how effectively its proposals would constrain the suppliers and lead them to coordinate their actions, thereby removing or reducing the availability of such “best deals”. Indeed, it is quite remarkable how precisely Ofgem has developed its retail policy over the last three years, and designed its present proposals, so as to maximise the likelihood of coordination between suppliers. If suppliers wished to be required to coordinate, it would be difficult to design a more effective regulatory policy. Appendix 1 explains in more detail why this is the case.

Ofgem then says that this more engaged consumer base “will have greater awareness of small and independent suppliers and may be more willing to explore the deals that these suppliers offer”. (para 4.10) Suppose that is true. But I have argued above that the small and independent suppliers will also be constrained by the proposals. And even if they expanded greatly from their present 1% of the market, their overall impact on competition and the prices available would be severely limited, at least for some years.

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<sup>13</sup> Ofgem, Draft Impact Assessment, paras 4.9, 4.11, 4.12

<sup>14</sup> By coordinated effects, Ofgem means “similar business strategies which in particular mean that suppliers tend to put their prices up at similar times by similar amounts”. It instances the range of dual fuel bills: at the end of 2006 the annual bill for a typical consumption level varied by £200 from highest to lowest supplier, but during 2009 and 2010 it fell to less than £40 and in March 2011 to £22. After recent price increases the range will be £24. Ofgem, Updated domestic proposals, para 2.51 p 39 (para 2.54 and Fig 6, pp 40-41)

## 10. Deeply discounted deals and efficiency savings?

What about the removal of the deeply discounted deals? Ofgem basically accepts that this will happen. However, it says that “over the longer term, a more engaged customer base should help to increase competitive pressure on suppliers and force suppliers to look for efficiency savings. We expect that if these cost savings are passed on to consumers, it will result in generally cheaper tariffs.” (para 4.12)

There are several qualifying, conditional and hypothetical steps in this argument. “Over the longer term” essentially means: lower price deals would indeed be removed from the market now, so prices in general would increase, but at some time in the future, perhaps in a matter of years, when customers are more engaged, there would be pressures leading to lower prices”.

Let us assume, again, that a more engaged customer base would increase competitive pressure on suppliers – although Ofgem says only that it “should help” – and force them to look for efficiency savings. But how much scope is there for efficiency savings that is not already being explored by the suppliers?

Ofgem says that it sees “little evidence of suppliers looking to reduce controllable costs”, and “we have no evidence to suggest that suppliers have become more efficient over time or are actively seeking to minimise the procurement costs of wholesale energy”, and “there has been no evidence of a meaningful reduction in indirect costs, which have increased in recent years, potentially contrary to what one might expect in a competitive market”.<sup>15</sup> These comments seem to be based on a brief comparison of four main components of costs over three years, then total costs over another two years. But it is not an obviously plausible argument: whether or not there is pressure to pass cost savings on to customers, there is no advantage to suppliers in failing to reduce their own controllable costs. Has Ofgem seriously looked for such evidence, and tried to control for other possible determinants of cost? It would not be at all surprising if indirect costs have increased in recent years, even for very efficient suppliers, given the significant increase in government and regulatory obligations that suppliers have been required to deal with.

Finally, Ofgem does not seem confident that any cost savings resulting from a more engaged consumer base would indeed find their way to customers. It says only “if” these costs savings are passed on to consumers, it will result in generally cheaper tariffs.

In sum, Ofgem essentially seems to accept that its proposals to increase customer engagement will lead to more coordinated effects and the withdrawal of lower priced offers. It claims that, “in the longer term”, such price increases will be offset by the effects of a more engaged consumer base. I argue that these arguments are unpersuasive, even if the customer base were more engaged. But is there any reason to believe that Ofgem’s proposals would indeed stimulate customer engagement in the first place?

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<sup>15</sup> Ofgem, Updated domestic proposals, paras 2.51, 2.62, 2.66 pp 39, 42, 44. See also Energy Supply Probe – Initial Findings Report, paras 7.83-7.86 and Fig 7.11 p 96.

## 11. Stimulating customer engagement

Ofgem cites the OFT as noting three requirements for customer engagement leading through to a switch of supplier.<sup>16</sup>

“Engagement requires consumers to be able and have an incentive to

- **Access** relevant market information
- **Assess** the offers available to choose what is best, as well as
- **Act** on their assessment of the information.”

Ofgem adds that “effective engagement also requires consumers first to be **Aware** that they could find a better deal if they take trouble to shop around”.

These are valid factors, especially Ofgem’s critical point about the prior need for awareness. Ofgem describes how various elements of its package address these four factors. So how comprehensively does Ofgem’s package provide or improve the critical incentive to be aware of beneficial opportunities to shop around? Ofgem says that “our RMR package focuses on ensuring that customers are aware of choices”. But then it says that “We are not looking to address the incentive consumers have to engage in the market to the extent that this is driven by factors such as consumers’ sensitivity to prices and brand loyalty”.(para 1.32 p 17)

This is most odd. Ofgem wishes to increase customers’ ability and incentive to engage in the market, but it looks only at factors such as information and complexity, and not at factors such as sensitivity to price and brand loyalty. What do we know about the relative significance of these two sets of factors?

## 12. Information and complexity, or price and advertising?

Ofgem provides extensive references to its behavioural and other consumer research. It documents that many customers find the energy market complex and would like more simple choices. Whether Ofgem’s proposals would be perceived by customers as simplifying the situation is actually debateable – with 4 tariffs per fuel times 2 fuels times 3 payment methods times 13 present suppliers, customers would still have 312 different tariffs to worry about. (And with 14 different regional areas, there would be up to 4368 tariffs in the GB market as a whole.)

Even if customers did perceive the tariff situation as less complex, would that be sufficient to promote greater engagement? Ofgem claims that complexity is significantly hindering switching. However, its customer research does not seem to support this. 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)”.<sup>17</sup> 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 for tariff simplicity would simply not address the reasons that customers in that survey reported for not switching supplier.<sup>18</sup>

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<sup>16</sup> Ofgem, Updated domestic proposals, paras 1.31, 1.32, pp 16, 17, also para 2.15 pp 17-18.

<sup>17</sup> Ipsos Mori, *Customer Engagement with the Energy Market – Tracking Survey 2012*, A report prepared for Ofgem, 12 April 2012, pp 7, 22.

<sup>18</sup> I have discussed the limitations of the Ofgem research at greater length in Ofgem’s Procrustean Bed. For a more extensive critique, see also Oxera, *Economic appraisal of Ofgem’s domestic tariff*

A recent piece of experimental work may throw some light on this. It finds that “The complexity induced by product bundling, non-linearity and number of tariffs has an important role, but this is overstated if the explanatory power of inattention is neglected.”<sup>19</sup> It also comments that “even restrictive regulatory measures forcing tariffs to be linear and only four – with the potentially distorting effects on competition that such restrictions may have – would still only help partially, as consumers would need to pay attention to the choice of tariffs and many of them simply would not”. (p 28)

This concept of attention is consistent with economic analysis of the competitive market process.

“...mere availability does not does not guarantee that those needing information will have it. Even if information is staring them in the face they may simply not notice it, and remain unaware that there is anything further to be known. It is therefore necessary for producers, intent on winning the profits from innovatively serving consumer preferences, also to *alert consumers* to the availability and the qualities of goods.”<sup>20</sup>

What then makes customers aware of a better deal and pay attention, and alerts them to the relevance of information, and in turn leads them to engage in the market and to switch? Empirical evidence is that customers are more likely to switch the greater the gains to be made.<sup>21</sup> Surely to ignore this is to rule out of consideration perhaps the most important single factor that influences consumers’ incentives to be aware of relevant opportunities and to engage in the market.

Ofgem itself has carried out econometric research on this topic, and was able to explain over 80 per cent of the switching (churn) rate. It concluded

- “the largest single factor affecting a supplier’s churn rate is its relative price; however
- churn rates are affected by a far wider range of factors than relative prices; and
- the level of marketing expenditure is very similar to price in its effect on a supplier’s churn rate – the more it spends on advertising, the lower its churn rate.”<sup>22</sup>

Note, however, that it is not just a matter of spending money on advertising: the advertising needs to be effective in attracting the attention of customers. The previously cited economic analysis of the competitive market process, and the need to alert consumers, continues as follows.

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*proposals: an appropriate intervention to increase consumer engagement?*, prepared for Scottish Power, March 2012.

<sup>19</sup> Stefanie Sitzia, Jiwei Zheng and Daniel John Zizzo, “Complexity and Smart Nudges with Inattentive Consumers”, CCP Working Paper 12-13, University of East Anglia, November 2013, Abstract.

<sup>20</sup> Israel M Kirzner, *How Markets Work: Disequilibrium, Entrepreneurship and Discovery*, IEA Hobart Paper No 133, 1997, p 55, available at [www.iea.org.uk](http://www.iea.org.uk).

<sup>21</sup> “Our model predicts well the factors which motivate activity for the consumers in our sample, and underlines the importance of anticipated gains as a major stimulus ...”. Catherine Waddams Price and Catherine Webster, “Effective empowerment: Empirical estimates of consumer switching behaviour”, ESRC Centre for Competition Policy, University of East Anglia, February 2012, p 22.

<sup>22</sup> Ofgem, Energy Supply Probe – Initial Findings Report, 6 October 2008, para 4.14 pp 49-50.

“Clearly there is a role for advertising beyond ‘providing information in response to consumer demand’. There is, in addition, a role for advertising to grab the attention of potential consumers and direct them both to the information and to the goods that are available. ... [I]n a world of complexity, change and uncertainty, it is inevitable that consumers *are* imperfectly aware of the qualities and promise of the multitudes of goods. The need to alert consumers to *what they do not know that they do not know*, is very real. ... From the mainstream perspective, advertising makes sense only as a weapon in the arsenal of the monopolist. From the perspective on advertising described here, however, advertising is plainly a tool *with which to compete*. ... The producer who judges more correctly what kind of dramatic advertising message will best awaken consumer interest has the more successfully served those consumers.”

Ofgem has thus put itself into an awkward situation. It proposes to reduce tariff complexity in order to increase customer engagement. I and others have suggested that its evidence for the effectiveness of this approach is questionable. In its previous work it has explored the factors determining the extent of customer awareness and engagement in the market. Consistent with economic analysis and research by others, it has found that price and advertising are the most important factors. Yet now, when it explicitly seeks to increase customer engagement, it focuses only on reducing tariff complexity and ignores its findings on the impact of price and advertising.

### **13. Whose judgement should be trusted?**

On this critical issue, whose judgement should be trusted? Who is likely to be best placed to understand actual customer behaviour? Ofgem has now spent a year or so on the tariff complexity issue, having “sought input from expert advisers on linguistics, semiotics and information design”.<sup>23</sup> It has also carried out customer research. However, the reliability of the stated customer intentions is again questionable. For example, Ofgem 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.

In contrast, the whole British 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. In addition, a dozen switching sites have competed to provide 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. It is surely fair to say that, in their view, price savings and advertising considerations are paramount.<sup>24</sup> And, to repeat, this is consistent with Ofgem’s own empirical research.

There is one final point to make here. The significance of tariff simplicity in driving customer awareness, engagement and switching is as yet a hypothetical conjecture. In

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<sup>23</sup> Ofgem, *Updated domestic proposals* 3.28.

<sup>24</sup> I have heard it said, for example, that the lowest price supplier on any website ranking can expect to attract as many customers as it wants, the second and third ranked supplier can expect a dozen acceptances, and lower ranking suppliers no response at all. Whether or not this is literally true, there is no doubt that suppliers and switching sites have a deep knowledge, based on experience, of what drives customer switching.

contrast, the significance of price savings is a demonstrable fact. Yet Ofgem is not only focusing on tariff simplicity as a driver of customer engagement *to the exclusion of* price savings, it is doing so *at the expense of* price savings. That is, in order to achieve the hypothetical benefit of tariff simplicity, Ofgem is accepting that the low price opportunities that have been demonstrated to drive switching will have to be sacrificed. Customers must suffer in order to test Ofgem's hypothesis.

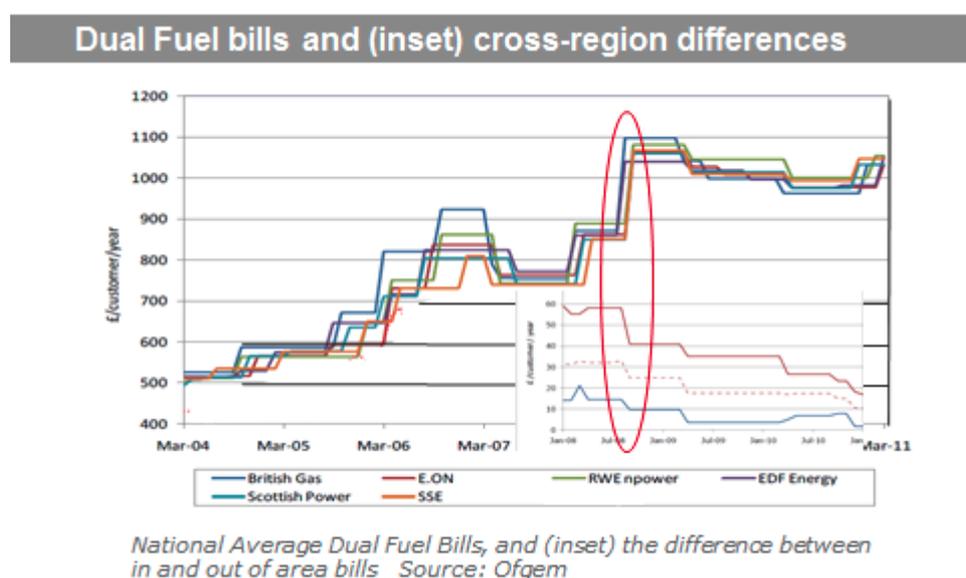
The empirical evidence suggests that there can only be one outcome. The net effect of the proposals to reduce tariff complexity would be less customer awareness, less engagement and less switching, not more. In consequence, there would be less competitive pressure in the retail energy sector, not more; prices and retail profit margins would increase, not decrease; and customers would be less satisfied, not more.

## II Ofgem has been here before

### 14. Ofgem's non-discrimination condition

In 2009, Ofgem expressed concern that incumbent suppliers were charging higher prices to their “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 “out-of-area” customers. Ofgem was concerned that the in-area customers were generally less actively engaged in the market, and a higher proportion of them were vulnerable customers. With the aim of securing the lower out-of-area prices for the in-area customers, Ofgem introduced its non-discrimination condition to prohibit such price differentials for three years, by means of standard Licence Condition SLC 25A.

Ofgem's subsequent publications show what actually happened. The major suppliers did indeed equalise their prices, as required - but as ought to have been expected they did not do so by lowering their in-area prices. Instead, they raised their out-of-area prices. The licence condition did not increase the effectiveness of competition, it reduced it.



**Figure 1 The impact on prices of the non-discrimination licence condition**

Professor Richard Green drew attention to this in response to an earlier Ofgem consultation.<sup>25</sup> Professors Hviid and Waddams Price have since studied the theory and impact of the non-discrimination condition more thoroughly.<sup>26</sup> They conclude that “the most likely net result of prohibiting geographical discrimination on prices is to raise them all, as predicted by the theoretical literature ... Although price differentials have fallen, the rising levels of both gross and net margins since the clauses were introduced provide evidence that this has occurred.” They also note that Ofgem “found many indicators that competition had deteriorated in its 2011 Retail Market

<sup>25</sup> R Green, Response to Ofgem consultation, 10 April 2012. He submitted the present Figure 1, drawing on two Ofgem figures, noting “a large increase in the level of the average bill at almost exactly the same time that companies started to reduce their cross-region differences”.

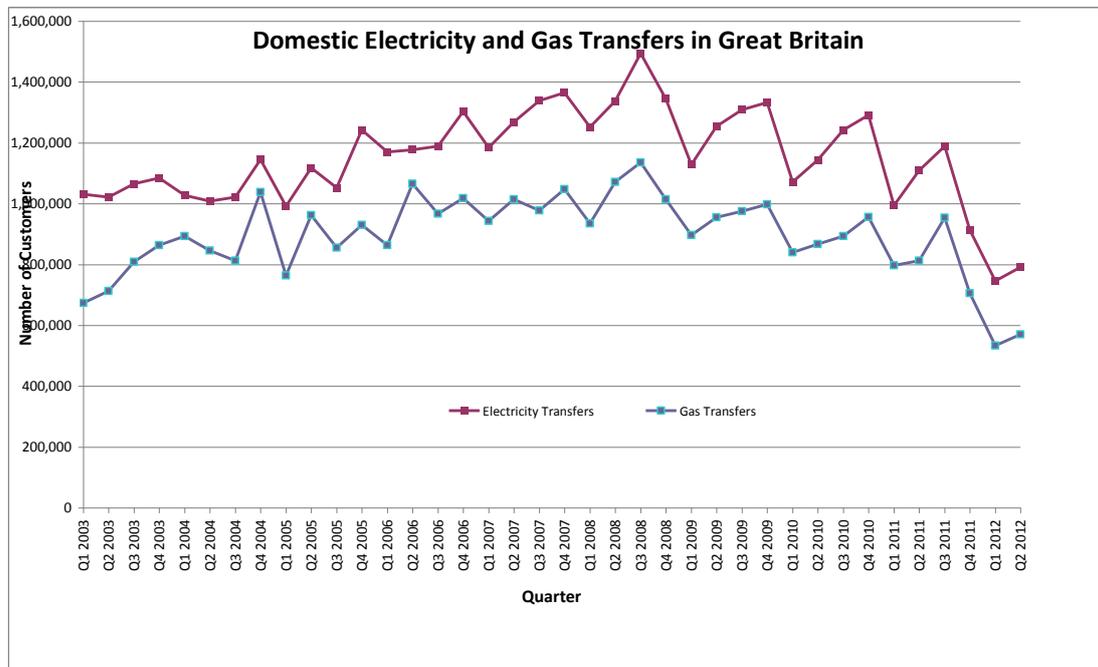
<sup>26</sup> M Hviid and C Waddams Price, “Non-discrimination clauses in the Retail Energy Sector”, *The Economic Journal*, Vol 122, August 2012, 236-252.

Review. These would follow from the weakening competitive threat from the entrants in each region.”

### 15. The impact on switching

One of Ofgem’s indicators of weakening competition was the declining rate of customer switching from one supplier to another. Ofgem argues – correctly – that this reduces the competitive pressure on suppliers. But when did this decrease in switching start and why did it happen?

Figure 2 shows the extent of customer switching over the last ten years. The number of electricity plus gas transfers between suppliers increased rather steadily from 568,000 customers per month in first quarter 2003 to 877,000 customers per month in fourth quarter 2008. In the four years since then the number has fallen back to an average of 440,000 per month in the first two quarters of 2012, a reduction of more than 20% on the number in early 2003, and a reduction of 50% on the peak in late 2008.



**Figure 2 The increase then decrease in customer switching<sup>27</sup>**

What caused this remarkable reversal of the trend in customer switching? Energy price movements might have played a part, but they varied over the period, and there is no established link between price changes and switching. The cessation of doorstep selling by major suppliers – which Ofgem strongly encouraged – may be relevant, since the major suppliers had found doorstep selling the most cost-effective means of attracting customers. But it was July 2011 before the first supplier abandoned doorstep selling, by which time the decline in switching was well underway, and it was a year later before the last supplier ceased doorstep selling. A more likely explanation for the reduction in switching is a rational response by customers to the

<sup>27</sup> DECC, Transfer statistics for the gas and electricity markets in Great Britain, 29 March 2012.

removal of attractive switching opportunities as suppliers raised their out-of-area prices.

The evidence thus suggests that Ofgem was primarily responsible for the significant reduction in customer switching over the last four years. This in turn reduced competitive pressure on the major suppliers, with the impact on prices and profit margins that have been mentioned above and documented further below.

## **16. The impact on vulnerable customers**

Even though customers in general suffered from Ofgem's policy, can it be argued that vulnerable customers have nonetheless benefited? Unfortunately not. Hviid and Waddams Price specifically examine this question. They note that there has been an impact in relative terms – but only in the sense that other customers have been made worse off. This is an 'equal misery' policy that Ofgem would presumably not seek to defend.

Vulnerable customers themselves are in fact worse off insofar as some of them will have been deprived of the lower price offers. "... almost a quarter of households with at least one 'vulnerable' characteristic will have lost immediately from the reform, as they are with an electricity entrant who has raised prices (out-of-area) to reduce their differentials." (p F246)

Furthermore, "firms' responses to the non-discrimination clauses may have generated further detrimental distributional effects". This is because the major suppliers responded to the restrictions on in-area versus out-of-area competition by competing more actively in other respects, for example by offering lower discounts for online tariffs. "...since the introduction of the non-discrimination clause the average offline tariffs have increased but the size of the discounts offered against these for online tariffs by the main players has increased dramatically". (p F247) Unfortunately, "vulnerable customers generally have lower access to broadband, raising concern for those who may find it difficult either to access these offers or to understand their temporary nature". More recently the size of these discounts has reduced.

## **17. Alternative theories of competition**

Why did Ofgem wish to prohibit price differentials? And why did its predictions turn out not to be right? It is important to understand Ofgem's thinking and the full impact of the non-discrimination licence condition, because the same failure to understand how the market works is now leading Ofgem to propose restrictions on competition that will have a much greater adverse effect on customers.

Ofgem has not espoused the argument that differential prices are undesirable per se.<sup>28</sup> Its analysis has focused on price discrimination from an economic and market perspective, with particular reference to the exploitation of market power. Suppliers in

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<sup>28</sup> Some might argue that it would be unfair if those customers who are active in the market get a lower price than those that are not. On this basis, fairness would mean that it would be desirable to equalise prices regardless of whether that led to an equalising down or an equalising up. Others would object to this interpretation, and indeed some have argued that it would be unfair if those customers who are active in the market were not able to get a better price than those that are not.

the market charge lower prices to those customers with more elastic demand, that is, the active customers that are liable to go elsewhere. Meanwhile they can charge higher prices to those customers with less elastic demand, the passive customers that are unlikely to move.

But does this mean that prohibiting price discrimination will improve the situation? Ofgem's thinking seems to have reflected what might be called a cargo-cult theory of competition.<sup>29</sup> Ofgem reasoned that under perfect competition, there would be no discrimination in prices between different customers. It observed that there was such price discrimination, therefore competition was not perfect. It concluded that if it prohibited price discrimination, this would represent a useful step towards perfect competition by making competition more effective. In the event, despite the equal prices, this perfect competition did not arrive. In fact, the prohibition made competition less effective.

In the present British energy sector, perfect competition is not a relevant or helpful benchmark. It is not a realistic alternative. The reality is that incumbent suppliers inherited a proportion of customers who are not active switchers. Hviid and Waddams Price review the modern economic literature on competition, and analyse how a non-discrimination rule would play out in such a situation.

In very simple terms, incumbent suppliers will charge a price to their in-area customers that covers their overhead costs, perhaps a bit more. This price would be above their incremental cost of serving additional customers in other markets. If they were allowed to attract other customers at a price below their average cost but above their incremental cost, they would find it profitable to do so. But if they were required to charge a uniform price to all their customers, it would be more profitable for them, and less risky, to focus on their home markets. In other words, if they were allowed to charge differential prices they would compete, if they were required to charge uniform prices they would not.

If suppliers do compete, their lower prices out of area force the other incumbent suppliers to reduce the prices to their own in-area customers, so as not to lose them. So not only out-of-area customers gain from this process, in-area customers are protected too.

In other words, differential prices do not indicate the absence of competition. In the circumstances of the British energy sector they are the very means by which incumbent suppliers compete with each other. In such circumstances, prohibiting differential prices is tantamount to prohibiting a central means of competition.

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<sup>29</sup> During World War II, US and Japanese planes delivered or airdropped cargo (including supplies and armaments) to their forces in the Pacific islands. This ceased at the end of the war. The islanders, who had often indirectly benefited from this cargo but were uncomprehending as to why it arrived, reasoned that they would attract the cargo if they duplicated the airport facilities they had seen on the ground. To that end they constructed planes and terminal buildings made of bamboo and straw, then waited for the cargo to arrive. But it did not come.

## **18. Competition and complex prices**

A similar line of argument applies to the concern about complex prices. Yes, the energy sector is indeed characterised by a great variety of different options, at different prices and on different terms. Yes, it can indeed be confusing for customers to know what is best for them. The behavioural economics literature that Ofgem references has indeed suggested that this complexity and confusion can lead to various problems and limitations in customer decision-making. It is understandable that customers say “Electricity and gas are simple products, we just want the best price.”

However, it does not follow that the best solution is to try to abolish complexity by constraining suppliers to charge only simple prices. There are reasons why prices are complex even in a fully competitive energy market. Different prices for different products are means of competing, not of preventing competition. To try to simplify prices and products is to risk making customers worse off, and tantamount to preventing rather than promoting competition. Appendix 2 sets out this argument in more detail. Appendix 3 shows that Ofgem’s focus on a few main tariffs comes at the expense of customers of minority products and innovation, thereby discouraging developments that could benefit all customers over time.

## **19. Increasing retail supply margins**

To update the Hviid and Waddams Price research, Figure 3 and the accompanying table reproduce Ofgem’s latest calculation of energy suppliers’ profit margins, net of energy and other costs.<sup>30</sup> Until mid-2009, when Ofgem introduced its non-discrimination condition, the average rolling net margin on a dual fuel bill was consistently negative. But since then it has been consistently positive. For the year centred on December 2008, the average net margin for a dual fuel customer was (minus) £25 per year. A year later it had risen to £40. At present it stands at £70. Ofgem’s latest prediction is an average of £100 over the next year, peaking at £120 over the next three months.

Electricity-only and gas-only net margins have increased too, electricity less sharply and gas more sharply.

## **20. Factors potentially explaining the increase in retail profit margins**

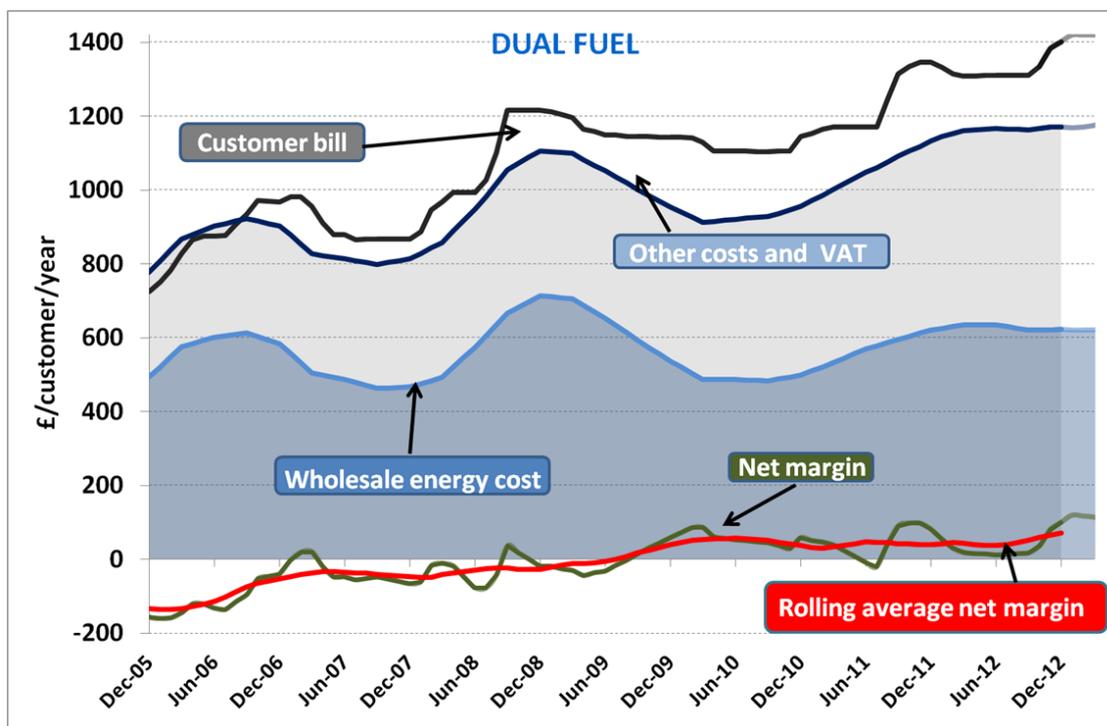
What led to the increase in net retail margins? Changes in wholesale costs and regulatory costs would impact on total prices but not, except temporarily, on net profit margins, at least as a percentage.

Ofgem has already conjectured an explanation for increases in net margins during the first part of the period shown in Figure 3. Looking at retail prices over the period January 2004 to December 2008, Ofgem indicated that British Gas was generally the price leader and, except in 2007, was willing to accept a loss of market share in order to sustain increased prices.<sup>31</sup> This is consistent with market share data: British Gas’s

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<sup>30</sup> Ofgem, Electricity and Gas Supply Market Indicators, 19 December 2012.

<sup>31</sup> “British Gas consistently priced above other major suppliers over this period, until it dropped its prices in early 2007 as a result of accelerating customer losses. Most other suppliers soon followed by



**Figure 3** Typical dual fuel customer bill, costs and total indicative net margin for the next 12 months.

**Changes in retail bills, costs and total indicative net margin for the next 12 months – December 2012**

Dual Fuel	Year				
	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12
Customer bill	£1,215	£1,145	£1,145	£1,345	£1,400
Wholesale costs	£715	£535	£500	£620	£620
VAT and other costs	£390	£415	£455	£510	£550
Gross margin	£110	£190	£190	£210	£230
Operating costs	£125	£130	£130	£130	£130
Total indicative net margin for the next 12 months	-£20	£60	£60	£80	£100
<b>Rolling net margin</b>	<b>-£25</b>	<b>£40</b>	<b>£35</b>	<b>£40</b>	<b>£70</b>

*Notes: 1) Customer bill is for standard tariffs, weighted by payment method and market share. Average figures assume electricity consumption of 4MWh/yr, gas consumption of 16.9MWh/yr. Figures rounded to nearest £5 and may not sum due to rounding. Gas and electricity bill values may not equal the dual fuel bill partly reflecting different market shares for dual fuel and single fuel customers.*

*2) The indicative net margin for a dual fuel customer may not equal the sum of the gas and electricity indicative net margins, partly reflecting different market shares for dual fuel and single fuel customers.*

lowering prices, although EDF Energy remained significantly more expensive. During the first few weeks of 2008, five out of the Big 6 raised prices in quick succession and to similar levels. In the last round, record price rises have been implemented by the Big 6, with British Gas re-establishing itself as the highest priced supplier.” Ofgem, Energy Supply Probe, Initial Findings Report, October 2008, para 7.2 p 72.

share of the gas market fell from 59% in January 2004 to 44% in June 2008. SSE increased its share of both markets, but the changes in market shares of other suppliers were relatively small.<sup>32</sup>

During the later period, from mid-2008 onwards, there were no further significant changes in market share. British Gas had a gas market share of 44% in June 2008, in August 2010 it was still 43% and in June 2012 it was still 42%.<sup>33</sup> British Gas had lost 15% of the market in the previous four years and only 2% in the next four years. British Gas was no longer ceding market share in order to sustain increases in prices and profits. Nor were there significant changes in the market shares of other major suppliers. What then was enabling the significant increase in supplier profitability? Attention necessarily turns to regulatory policy.

Regulatory policy potentially affecting the competitive market and supplier profit margins had three main components:

- in February 2008 Ofgem launched its Energy Supply Probe which eventually led to two new licence conditions effective from 1 September 2009: one requiring any difference in the terms and conditions of different payment methods to be cost-reflective, the other prohibiting undue discrimination in any terms and conditions. However it was clear from earlier discussions which way Ofgem's thinking was tending. The major suppliers responded, and by October 2008 Ofgem was reporting that the earlier 10% differential between in-area and out-of-area prices had reduced to about 6%.<sup>34</sup> The non-discrimination condition ceased to have effect in September 2012 but it continued to have influence because Ofgem warned suppliers not to return to unjustified pricing practices.<sup>35</sup>
- from the opening of domestic retail markets in 1997-9 there were complaints about doorstep selling. Ofgem introduced then extended various rules of conduct. But regulatory and consumer group pressure increased. In July and August 2011 the two largest suppliers abandoned doorstep selling. By October 2011 three more suppliers had followed. The sixth followed in July 2012.
- in March 2011 Ofgem's Retail Market Review Initial Findings expressed concern about the complexity of tariffs and urged suppliers to simplify their tariffs. In November 2011 the two largest suppliers

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<sup>32</sup> Over the same period SSE increased its market share from 7% to 15%, the other four major suppliers increased their market shares slightly. In the electricity market, SSE increased its market share from 13% to 19% and there were small changes in the market shares of the other major suppliers.

<sup>33</sup> Ofgem, The Retail Market Review – Findings and Initial Proposals, Supplementary appendices, 21 March 2011, Fig 1 p 50.

<sup>34</sup> Ofgem, Energy Supply Probe, Initial Findings Report, para 1.17

<sup>35</sup> "SLC 25A was primarily introduced to prevent suppliers from charging higher prices for their incumbent customers, compared to their non-incumbent customers without objective justification. We were concerned the less active group of incumbent customers may not be benefiting from competition to the same extent as the more engaged consumers. For example, charging higher prices for their "in-area" customers compared to their "out-of-area" customers. ... While we have decided not to re-insert SLC 25A for a further period, we will be monitoring very closely the pricing practices of all suppliers as part of our general market monitoring activities. If at any time we have compelling evidence to suggest pricing practices which are unjustified are returning to the market, we may commence a full review of this area and consider developing new licence conditions to address our concerns." Ofgem, Decision on Standard Condition 25A in the Gas and Electricity Supply Licences, 26 October 2012.

indicated their intention to do this. Over the period February to November 2012, five of the six major suppliers implemented some kind of tariff simplification.

The expected advent of the non-discrimination licence condition was broadly coincident with the significant increase in supplier profitability in mid-2008. The abandonment of doorstep selling in late 2011 was not coincident with an increase in supplier profitability, but an impact on the price increases the next year cannot be ruled out. The simplification of tariffs in mid-2012 was broadly coincident with the increase in profitability at that time.

## **21. Quantifying the increase in net retail margins**

What do the increases in indicative net retail margins add up to? Ofgem launched its Energy Supply Probe in February 2008 and suppliers began to modify their tariffs shortly afterwards. I have therefore taken as the pre-Probe benchmark the year ending February 2008. This corresponds to Ofgem's rolling net margin for the year centred on August 2007, covering the 13 month period February 2007 to February 2008. Table 1 shows these net margins for August 2007 and for each subsequent year, up to August 2012. I have then used Ofgem's forecast rolling net margin for the 12 month period from December 2012 as a forecast for the August 2013 rolling net margin.

With 16.8m dual fuel accounts nationally, the increase in net profit margin from mid-2007 onwards has been worth about £1.4 bn per year over the last three years (2010-2012). The prospective increase to £100 will bring the total to over £2bn per year in 2013. The total for dual fuel accounts from 2007 to date is £7.4 bn.

For the 9.2m electricity-only accounts and 4.6m gas-only accounts, the increases have been about £0.1bn and £0.4bn, respectively, over the last three years, making a total of about £1.9bn per year. The projected increases in 2013 (£0.3bn and £0.6bn) imply that aggregate net margin next year will be about £3bn higher than in 2007. The total increase in retail profits since 2007 will be about £10bn.

The nature of the costs included in Ofgem's data is not entirely clear. It might be argued that higher margins are needed to cover the costs of financing the increase in wholesale and other costs over this period. In very round terms, customer bills will have increased by about half over the period from mid-2007 to mid-2013. But the net margin has increased even as a percentage.<sup>36</sup> And even a generous allowance for financing costs would still leave a substantial increase in net margin to explain.

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<sup>36</sup> In March 2011 Ofgem calculated the energy retail margin as a percentage, defined as company earnings before interest and tax (EBIT) divided by sales. It found that "energy retail margins have averaged 1.6% since 2005. In 2010, energy retail margins are estimated to have risen to 4.2%." Ofgem, The Retail Market Review – Findings and initial proposals, 21 March 2011, para 1.5 and Fig 1, pp 40-1.

<b>Table 1 Calculation of value of increases in retail net margins since 2007</b>			
Year (August)	Net rolling margin £	Increase over 2007 £	Value of increase £m
<b>Dual Fuel (16.8m)</b>			
2007	-35	0	0
2008	-25	10	168
2009	10	45	756
2010	55	90	1512
2011	45	80	1344
2012	45	80	1344
2013 est	100	135	2268
Total dual fuel			£7392m
<b>Electricity (9.2m)</b>			
2007	20	0	0
2008	15	-5	-46
2009	10	-10	-92
2010	30	10	92
2011	35	15	138
2012	30	10	92
2013 est	50	30	276
Total electricity			£460m
<b>Gas (4.6m)</b>			
2007	-40	0	0
2008	-15	25	115
2009	25	65	299
2010	45	85	391
2011	45	85	391
2012	55	95	437
2013 est	90	130	598
Total gas			£2231m
<b>All accounts</b>			
2007			0
2008			237
2009			963
2010			1995
2011			1873
2012			1873
2013			3142
Total all accounts			£10,083m
Source: Ofgem rolling net margin data			

Ofgem would emphasise that the Supply Market Indicator focuses on standard tariffs, is just one indicator, and is heavily simplified. And, of course, these calculations are

very rough and ready. There is a question whether a negative retail profit margin is an appropriate benchmark, although the suppliers seem to have survived with an even more negative margin for at least four years before the non-discrimination condition.

Nevertheless, these figures do suggest a very significant transfer from customers to the major energy suppliers, possibly totalling up to £10bn over the last half dozen years. Ofgem has not published any more accurate calculations, nor offered any other explanation for the phenomenon, other than the restrictions on retail competition that have followed from its policy. At the time of introducing the non-discrimination licence condition it promised an investigation into the effects within three years, so as to inform the decision whether to renew it. It failed to carry out this investigation. The reason for the significant increase in profits would merit further investigation before the same policy is extended further.

## **22. The implications for future policy**

The longer term consequences are even more serious than the increases in prices alone. 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.

The Energy and Climate Change Select Committee has already expressed this sentiment.

We recommend that Ofgem should be prepared to amend the measures it has implemented under RMR if there is no evidence after 12 months that they are making it easier for consumers to switch. In particular, Ofgem should be prepared to reconsider regulating the standing charge, or abolishing standing charges and introducing a single unit rate.<sup>37</sup>

For the reasons given above, these measures will reduce competition further and make the situation worse. There will then be a demand for direct controls on profit margins, on energy purchasing policies, on wholesale transfer prices and eventually on final retail prices.

If a competitive market is perceived to have failed so comprehensively, what then is the case for continued private ownership? But 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?

These are serious consequences. They follow from the understandable but mistaken belief that enforcing simple tariffs will increase rather than reduce competition.

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<sup>37</sup> Select Committee on Energy and Climate Change - Fifth Report, Consumer Engagement with Energy Markets, 18 December 2012, para 38.

### III The way ahead

#### 23. Clearer information and fairer treatment

The aim of Ofgem's Retail Market Review – “to encourage and equip consumers to engage effectively in the market” – is not in itself a problem. Indeed, it is commendable and consistent with Ofgem's statutory duties. The problem lies in the methods that Ofgem has proposed to achieve this aim. Its proposals are to make the market “simpler, clearer, fairer”. I have argued that those elements of Ofgem's key proposals that sought to make the market simpler would restrict energy tariffs and would thereby remove attractive offers that customers valued, reduce competition, increase prices and work to the disadvantage of customers without encouraging them to engage effectively.

Of Ofgem's six key proposals, only two referred to making the market simpler. What about the other four proposals?

Three of them aim to provide customers with clearer information. These are

- “require suppliers to give consumers personalised information of the estimated savings they could make if they switch to the supplier's cheapest deal
- introduce a Tariff Comparison Rate: a common currency to allow customers to compare tariffs across the market
- require suppliers to give all customers a new improved Annual Statement with the personalised information a consumer needs to engage in the market, and to provide other ‘calls to action’ on bills and in the letter notifying consumers of price increases.”<sup>38</sup>

Ofgem believes that these measures will give customers more and better and relevant information, thereby encouraging the confidence and ability to engage more effectively in the market. Critics might question the plausibility of this belief, and argue that the required measures represent undesirable further steps towards regulatory micro-management that will be burdensome and costly to suppliers, Ofgem and customers alike. What will they achieve that previous provisions of this kind did not? Will they create more uncertainty and problems than they solve? Will they, on balance, yield benefits to consumers that exceed the costs that customers will end up paying? These issues are matter for debate and discussion with customers, suppliers, consumer bodies and others. There might also be scope to trial the proposals in conjunction with the suppliers.

The key proposal to make the market fairer is to “introduce new licence conditions to require suppliers to treat their customers fairly and to embed this principle throughout their business”. This sounds like an attractive idea – who could be against suppliers treating their customers fairly? In fact, it is very worrying. The concept of fairness is so subjective and emotive that it is not appropriate as the basis of a licence condition. It puts the onus on the supplier to guess what the regulator might mean by fairness, then allows the regulator to come back later and say “That's not fair, you are in breach, here is your fine”. A licence condition of this kind would give no tangible

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<sup>38</sup> Ofgem, Updated domestic proposals, p 8.

protection to customers. But it would increase risk and therefore the cost of capital, which would translate into higher prices for customers. It would discourage suppliers from innovating. It would encourage suppliers to coordinate their policies so as not to be exposed to regulatory risk. It is liable to be a prime example of how a licence condition should not be written.

Ofgem raises various other possibilities. One is personalised market best deal information. This would “require suppliers to give the least active and most vulnerable consumers direct and personalised information about the cheapest deals across the whole market”.<sup>39</sup> Personalised information could be helpful, and consumers will want to consider opportunities across the market as a whole. But Ofgem rightly acknowledges that “we cannot be sure that the measure would succeed in engaging the most sticky and vulnerable consumers in the market”.<sup>40</sup> There are other concerns. If such a scheme is going to be workable it will require considerable standardisation of prices and terms. Is it really conducive to a more competitive market to require suppliers to coordinate in this way? And both economic analysis and empirical evidence demonstrate the importance of appropriate advertising to make consumers really aware of the existence of worthwhile opportunities. Is it really likely that a supplier that does not wish to lose a customer will market a tariff opportunity as effectively as a supplier that wishes to attract that customer?

Ofgem discusses the scope for facilitating the role of intermediaries such as switching sites. This could be helpful, but again there are potential dangers. Ofgem might begin to insist that all switching sites either include or not include certain kinds of data, or certain kinds of tariffs or terms, or certain methods of comparison etc. Given Ofgem’s recent record on competition, this would not be in the interests of customers themselves. There is merit in allowing switching sites the ability to compete by offering different methods of comparison if they judge this would attract the interest of more customers.

DECC has asked “whether there are any barriers that need to be addressed to allow collective switching and purchasing to flourish”.<sup>41</sup> This is a sensible direction to explore. Perhaps the most promising avenue of enquiry is DECC’s related question whether “there is benefit in seeking to establish a co-ordinated network of voluntary organisations and community groups that work proactively with trained energy advisers to support vulnerable consumers to engage in the energy market”. This would focus directly on the core concern, and would address it by extending the benefits of the market to a wider range of consumers.

## **24. Conclusions**

The absence of any economic analysis of competitive markets has led Ofgem and now DECC to propose a set of measures that would be inconsistent with the duty of the Gas and Electricity Market (GEMA) to regulate wherever appropriate by promoting effective competition. Far from promoting competition, the present proposals pertaining to tariff simplicity would in fact restrict and distort competition.

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<sup>39</sup> Ofgem, Updated domestic proposals, p 9.

<sup>40</sup> Ofgem, Frequently asked questions on the Retail Market Review, 19 December 2012, p 6.

<sup>41</sup> DECC, Ensuring a better deal for energy customers, p 8.

This is not just an abstract argument about competition. The restrictions themselves, as well as the consequent reduction in competition, would increase prices and retail profit margins. In addition, the limitation to four tariffs would effectively preclude innovation. *All* customers would be worse off, *including those vulnerable and less active customers that these proposals are particularly intended to protect*. The proposals would therefore be inconsistent with the principle statutory objective of GEMA to protect the interests of existing and future consumers. The only potential beneficiaries would be the major energy suppliers, who would be able to enjoy quieter and more profitable lives unhindered by active retail competition.

A rough calculation suggests that Ofgem's previous excursion into restricting competition, coupled with the initial impact of its present proposals, could now be costing energy customers up to £3bn per year, and could soon have cost customers about £10bn to date. This needs investigating before the policy is extended.

If the restrictive aspects of the Ofgem and DECC proposals were dropped there would be scope for discussion as to how better information could be provided to customers in a prudent and not unduly costly and intrusive way, and how suppliers could be given clearer guidelines on dealing with customers. DECC has encouraged the concept of collective switching. It now wishes to explore other measures including the potential benefit of a support network to assist vulnerable customers to engage in the energy market. These and other measures would work with the competitive market instead of against it, and deserve further exploration.

## 25. Appendix 1 Coordinated effects

How can we understand what kinds of regulatory actions are likely to give rise to coordinated effects, and of what kinds? We can learn from a pioneering analysis of oligopoly that began by assuming that the companies in an industry wished to collude, and asked how they would go about it. What problems would they have to address and how would they do it? Economic analysis suggested that the key challenge was to design, police and enforce a collusive agreement.<sup>42</sup>

Collusion is generally illegal or would be deemed anti-competitive. However, that problem is overcome if companies are acting in response to a regulatory requirement or request. Regulatory involvement that might require or lead to coordinated effects could therefore be a means to secure the desired end.

In this vein, suppose, entirely hypothetically, that the major energy suppliers in an industry wished to coordinate or restrict their pricing and product activities so as to increase their profitability. How would they go about it?

The first problem is that some suppliers might be keen to coordinate activities in order to limit competition – perhaps the largest suppliers with most to gain from maintaining the status quo – while other suppliers might be less keen or opposed – perhaps the smallest suppliers or those who hope or need to increase market share at the expense of the larger players. Some means must therefore be found of requiring all suppliers to participate. A regulatory obligation on all suppliers resolves this problem.

The second problem is that, even if all existing suppliers can be persuaded to agree, new entrants might not do so. So it must be a condition of entering the industry that the restriction is imposed on new entrants. Again, regulation is a solution.

The third problem is that, even if all existing and future suppliers can be persuaded or required to agree, some might cheat. For example, if all agree to a common price, some might offer secret discounts. So some form of monitoring and enforcement is required, to check on the activities of each supplier and to discipline those suppliers that are found cheating. Another role for regulation.

The fourth problem is to agree the nature of the coordination or restriction. Judgement and realism is called for. Back in 1998, when each ex-monopoly supplier had only one tariff per payment type, agreement on prices might have been feasible. But ten years later, with the number of tariffs said to be in the hundreds, this would be too ambitious. In any case, would a regulator be willing to specify or approve a particular set of prices?

The solution is to go for something achievable, to restrict particular activities rather than to set prices themselves. So the suppliers might ask themselves: what single competitive activity poses the greatest threat to us, the activity that as suppliers and mainly incumbents we would most like to prevent ourselves from doing? Answer: the

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<sup>42</sup> George J Stigler, A theory of oligopoly, *Journal of Political Economy*, Vol LXXII, No 1, February 1964.

ability to charge a lower price out-of-area than in-area. If the regulator would just require all suppliers to charge the same price out-of-area as in-area, that would be the greatest single restriction on competition we could conceive of.

Along the same lines, it would be possible to make use of the EU obligation to ensure that prices to different payment methods reflect cost. Highlighting and enforcing that obligation would reduce the scope for suppliers to cut prices for some methods and not others. Suppliers would then have to compete by cutting prices for all payment methods across the board. That would be more costly for a supplier and would hence tend to deter suppliers from competing.

Suppliers might then consider the possibility of coordinated action to limit another competitive activity. They might ask themselves which selling technique was most cost-effective in attracting new customers, with a view to limiting or preventing its use. Answer: doorstep selling. If there were sufficient pressure from the regulator to stop that – for example, if there was evidence of mis-selling even in a very small percentage of cases – then suppliers could consider renouncing it altogether, and with any luck they could persuade consumer groups to urge them on.

Buoyed by their success, suppliers might now consider inviting the regulator to assist in further coordinating their prices, this time by actually setting part of the price. Initially, it would be prudent – and perhaps sufficient – to limit regulatory involvement to the main product, the standard variable tariff taken by about three quarters of their customers. It would not be necessary or indeed desirable for the regulator to set the whole of this tariff: that would mean regulatory control of their profit margins. But if the regulator could be persuaded just to set a uniform standing charge, that would enable the suppliers to coordinate energy charges with much less difficulty than coordinating tariffs with two or more components.

This would still be a big step, because the price of such regulatory involvement would be some loss of control over their own businesses. However, the reduction in their ability to undercut each other would be sufficiently profitable to outweigh this. Indeed, it would be even better, and easier to coordinate, if the regulator would require them to get rid of discounts for such things as online purchasing and dual fuel. Although there are cost and demand differences there which suppliers would otherwise like to continue to reflect, such discounts have been a significant source of competitive undercutting, so eliminating them would be very helpful. If they could be required to no longer offer tariffs with no standing charge, that would remove a particularly thorny and costly issue. Finally, explicit regulatory involvement in price setting could help take the sting out of future price increases.

But what if the regulator got cold feet and decided not to set a uniform standing charge? Plan B would be to concentrate on limiting the scope for suppliers to compete. If they could agree to limit the number and types of tariffs they could offer, this would reduce the number of competitive fronts that they had to monitor and defend. If all tariffs had to have two components, it would be much easier to coordinate than if some tariffs had one component and others had three. And if the regulator could specify that suppliers could only offer lower prices to any new customers if they also reduced their prices to all their existing customers, that would certainly put the dampers on undercutting, without preventing suppliers from

coordinating price rises generally. Furthermore, if they could have only four tariffs, that would effectively stop suppliers introducing new ones that might disturb the existing order.

Moreover, a maximum four tariff approach would provide an opportunity to plug a loophole that had emerged after the regulator had prevented them from competing by offering lower prices out-of-area. Suppliers had begun to get round this by offering lower prices in other ways – for example by offering all sorts of online discounts and temporary offers. They could put a stop to this if the regulator were to require *all* tariffs, not only variable tariffs, to be included in the four tariff maximum.

This would all look more feasible to suppliers than having the regulator set a uniform standing charge. But what if the regulator were apprehensive about Plan B too? Could other pressures be brought to bear? Perhaps get customers to support it? Ha ha, why would turkeys vote for Xmas? So what about politicians – perhaps they could be brought to see this as a way of blaming the companies for increases in final prices, and punishing them? Suppliers could find it worth taking a bit of blame if it meant being punished by higher profits. Or perhaps, on further consideration, a regulatory exhortation to simpler tariffs, even without a licence condition, would provide sufficient cover for a coordinated reduction in the range of competitive offerings? Just as a regulatory warning against returning to previous unjustified practices might well be sufficient to restrain price cuts out-of-area even if they were no longer formally prohibited.

All of this is purely hypothetical. I have no reason to believe that GB energy companies think or act in this way. But as Malvolio might have said if asked about energy suppliers, “Some are born coordinated, some achieve coordination, and some have coordination thrust upon them”. Why anyone, having thought this through, would want to thrust coordination upon energy suppliers is difficult to explain.

## **26. Appendix 2 Why are energy prices complex?**

Popular criticisms, and parts of Ofgem’s argument, reflect a view that tariff complexity is a deliberate device to confuse and exploit customers, or another way to exert market power by discriminating between more and less active customers. However, there are at least four reasons why energy prices are complex even in a competitive market - perhaps especially in a competitive market.

First, although electricity and gas may be simple products, suppliers offer many different ways of pricing them and paying for them. They may be purchased separately or together (dual fuel). They may be supplied at a fixed price or a variable price, or a mix of the two. Variable tariffs may or may not have assurances about no change in prices, and for different periods of time. Or the price might be related to some index such as the wholesale price or the oil price or the price of certain competitors in the market. It may be paid for upon receipt of the bill or by direct debit or by prepayment. Communication with the supplier may be offline or online. Or the electricity might be produced by different types or proportions of renewable energy. And so on.

Why do suppliers offer so many different options? One reason is that neither suppliers nor Ofgem know what kinds of terms customers would most prefer. Indeed, customers themselves probably don't know, since they may not have thought of many of these possibilities before. So suppliers are constantly searching for new ways to price and pay for energy that they think will keep and attract customers. In doing so, suppliers need to think about the quality/price tradeoff. If, for example, online billing reduces suppliers' costs, so they can offer lower prices, is online billing something that customers are prepared to accept in return for a lower price? Similarly, if green energy is more expensive to supply, is that something that customers are prepared to pay more for?

Competition is thus a discovery process, trying to find and provide what customers want. (At the same time trying to identify which suppliers are best at this discovery and provision.) One reason for tariff complexity is that the market has not yet found all the answers. Some of the products in the market today will survive, others will fall by the wayside. But neither suppliers nor Ofgem yet know which. This will always be the case. Smart metering will offer a multitude of additional possibilities not yet conceived of.

The second reason for tariff complexity is that customers have different preferences. They do not all want the same thing. They want electricity and gas but they have different preferences about the terms on which they want to buy it and the way they prefer to pay for it. This may reflect differences in income, or taste, or attitudes to risk, or other factors. Similarly, supermarkets stock many different varieties of groceries. The complexity of tariffs thus reflects the variety of human preferences and circumstances.

Third, there is a competitive aspect. If a supplier is offering only a variable price product, a competitor may be able to compete more effectively by offering a fixed price product, even though it may appeal only to a subset of the customers, than by offering the same variable price product at a marginally lower price. It may not be worthwhile for customers to switch in response to a slightly lower price. It may also be quicker and easier for the initial supplier to respond by cutting the price of its existing product than by developing a new product.

Fourth, is the point highlighted in connection with the non-discrimination clause, and discussed above. Offering different products or terms to new customers compared to existing customers may make it possible and profitable for suppliers to compete in a way that would not be possible, or not profitable, if they were required to offer the same price or terms to all their existing customers as to their potential new customers.

In sum, complex tariffs are not an aberration, or a sinister attempt by suppliers to confuse and exploit ignorant customers. They are an integral feature of a vibrant competitive market. Admittedly they can be confusing for some customers, and some assistance with coping with the market may be in order. But to force prices into a simple regulatory straightjacket will reduce, not increase, competition, and all customers will be worse off.

## 27. Appendix 3 Ofgem's attitude to consumer preferences and innovation

Ofgem's proposals suggest a rather dismissive and short-term attitude to consumer preferences, and to the above benefits of competition. For example, in discussing its fixed term tariff proposals it acknowledges that "those consumers who would prefer to be rolled over to a subsequent deal and not engage in the renewal process could be worse off as a result of our proposal".<sup>43</sup> However, it considers that these are likely to be 'active' consumers for whom the risk of frustration is low. It also acknowledges that "a prohibition on price increases and other adverse unilateral variations will restrict available tariff types, thereby leading to a loss of certain tariffs that may be favoured by some consumers (eg tariffs which track other tariffs)".<sup>44</sup> But it quotes two pieces of its research and concludes "Neither of these findings suggests that customers have a strong expectation to see non-fixed price fixed term tariffs in the market."

So, Ofgem's argument is that if not many customers are likely to be frustrated by removing some existing tariff options, there is no great objection to doing so. This view gives little or no weight to all the aspects of the competitive market process set out above. That is, it looks only at how many customers today would be frustrated by the removal of some type of tariff. It fails to consider that, over time, many more customers might come to value this type of tariff. It gives little weight to the preferences of a minority of customers if the majority don't at present care for it. Needless to say, despite protestations elsewhere in favour of innovation, it gives no weight at all to the possibility of new types of tariff not yet in the market. It fails to recognise that offering tariffs that only a minority might choose might nonetheless be an effective means by which some new entrant suppliers in a market are best able to challenge incumbent suppliers there. This is because these are products to which the incumbent supplier does not have an immediate answer and/or that do not threaten the challenging supplier's own customer base.

In sum, Ofgem has understandably focused on passive and vulnerable customers and the standard products that they consume today. Unfortunately, in doing so it has failed to appreciate the role that other customers and other products play in the development of better products for all customers in the future.

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<sup>43</sup> Ofgem, The Retail Market Review - Draft Impact Assessment for the updated domestic proposals, October 2012, p 7.16 p 66.

<sup>44</sup> Ofgem, Draft impact assessment, para 7.17 p 67.