Resist the temptation to intervene on energy prices

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The Government is preparing to "step in" because the energy market is "manifestly not working" for customers. As former British energy regulators, we want this market to be properly understood, and lessons to be learnt from past experience.

We have been here before. The chief executive of EnergyWatch expressed the same concern in 2008. Retail competition had been successfully introduced in the late 1990s but from 2004 prices rose rapidly. These were driven by rising global gas prices and by increasing social and environmental obligations on suppliers. But there was pressure to Do Something.

Ofgem's 2008 probe found "unfair price differentials" totalling £500m. Ofgem introduced a non-discrimination condition. The price differentials disappeared – but by increases in the lower prices, not reductions in the higher ones.

Ofgem also imposed strict constraints on direct marketing, including doorstep selling. Because of both policies, customers engaged less in the market – particularly poorer customers. The customer switching rate halved.

Suppliers competed by introducing new tariffs. Ofgem argued that these baffled customers. In 2012 Ofgem introduced a "simple tariffs" policy that limited the number and variety of tariffs. This did not assuage public concern, or restore the previous customer switching rate.

In 2014 Ofgem asked the Competition and Markets Authority (CMA) to investigate the energy market. In 2016 the CMA reported that Ofgem's "simple tariffs" policy had had an adverse effect on competition. It limited tariff variety, innovation and price competition. The CMA required Ofgem to end this policy.

There remains a major and understandable public concern that retail energy profits are too high, and most large suppliers have recently increased prices. But two of the six large suppliers have consistently made retail losses over the last eight years.

The CMA's investigation did find that there were customer detriments of £1bn to £2bn per year. But these were not conventional estimates of excess prices or profits. They were estimates of how much lower prices could be if the large suppliers were more efficient, as the CMA thought they should be.

The CMA acknowledged this, and identified a consequent problem with price control. "A large part of the detriment we have observed in the form of high prices is likely due to inefficiency rather than excess profits, such that if we were to eliminate the entirety of the detriment we have observed through a price cap it would create substantial losses for the sector as a whole."

Another public concern is that price differentials are unfair. Loyal customers on standard variable tariffs are charged more than customers who shop around and choose short-period fixed-price tariffs.

But differential prices, and discounts and cheaper products to keep the most active customers and attract new customers, are standard practice in many industries with overhead costs to cover. The undiscounted prices, too, are subject to competition, not least from over 50 new entrants, most of whom are still exempt from significant social and environmental costs imposed on larger suppliers. Retail energy profits are not excessive, loyal customers are not being ripped off, and there is no need to pressure consumers to be more active.

There is concern that poorer customers are less engaged and on the worst deals. Until 2008, switching rates were similar across the socio-economic range. Ofgem’s crackdown on doorstep selling led suppliers to move to online channels that excluded some poorer customers. But many new entrants are once again reaching these customers, using iPads to comply better with Ofgem’s direct marketing rules and prevent mis-selling.

Many local authorities, customer organisations and switching sites are also reaching out to poorer or less engaged customers, to enable them to benefit fully from the competitive market.

Energy prices have indeed gone up, which is a legitimate worry to customers, politicians and government. But the main determinants of energy prices are fuel costs, regulated distribution and transmission network costs, and the costs of environmental and social obligations.

Retail suppliers must recover these costs as well as their own costs: it is no use shooting the messenger. Competition is increasingly forcing all suppliers to be more efficient and to pass these benefits to customers.

The CMA majority concluded that a wide price cap “would – even during a transitional period – undermine the competitive process, potentially resulting in worse outcomes for customers in the long run. This risk might occur through a combination of reducing the incentives of customers to engage, reducing the incentives of suppliers to compete, and an increase in regulatory risk.”

The temptation to intervene further should therefore be resisted. The evidence is clear: regulatory interventions have been counterproductive. Retail energy price controls would have an adverse effect on a market that is working better than is generally realised – and would have ominous implications for other markets.

Stephen Littlechild, Sir Callum McCarthy, Eileen Marshall CBE, Stephen Smith, Clare Spottiswoode CBE