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Replacing the tariff caps and protecting vulnerable customers by harnessing the competitive process

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Nolan: a replacement for the price cap is Ofgem's absolute priority over the next few years

Ofgem CEO Dermot Nolan has said that finding a replacement for the price cap introduced at the start of the year in order to protect vulnerable customers is an absolute priority for the regulator over the next two to three years. He was speaking to the Commons Public Accounts Committee during an evidence session held on Monday 20 May. He described the price cap as having positive effects in the short-term but is capable of being gamed and limits innovation and efficiency in the long-term. Nolan also said that there needs to be some form of intervention in the long-term to help vulnerable customers, "perhaps some form of switching service". He said Ofgem would consult on a possible replacement system for the cap and would publish its findings by the end of 2019. (Cornwall Insight, Daily Bulletin, May 21, 2019)

1. Introduction

The CMA's Energy Market Investigation (EMI) Final Report (2016) found that several factors had Adverse Effects on Competition in the domestic retail energy market and recommended several remedies including a temporary cap on Prepayment Meter (PPM) tariffs. The majority of the EMI panel explicitly decided against imposing a wider cap on standard variable and default tariffs. However, the Tariff Cap Act 2018 required Ofgem to impose such a cap, for a limited period of time. It also required Ofgem to carry out a periodic review into whether conditions for effective competition are in place, and to recommend whether the tariff cap should be removed. In addition, the Act required Ofgem to consider, before and after the tariff cap ceased, whether it was appropriate to provide protection against excessive charges for particular categories of domestic customers, whether some customers would suffer from excessive tariff differentials and whether some vulnerable customers needed protection; if so, Ofgem should take such steps as it considered appropriate.

Ofgem CEO Dermot Nolan recently indicated his view, summarised above, that "finding a replacement for the price cap … to help vulnerable customers is an absolute priority". Ofgem has begun to consult on some of these questions, such as the conditions for effective competition. Ofgem has now said explicitly that a key priority for the period 2019 to 2023 is "development of a successor regime to the current default tariff price cap, which must

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expire no later than 2023". [1] One of Ofgem's stated aims is to "Protect consumers, especially the vulnerable, stamping out sharp practice and ensuring fair treatment". (p 7) It aims to achieve this by (inter alia) "using targeted interventions for a fairer market: we will intervene to provide backstop protections – such as the default tariff cap - to ensure all consumers pay an acceptable price for an acceptable level of service", and by giving "extra consideration for vulnerable consumers".

However, there is by no means universal agreement with the CMA analysis, concerns and remedies upon which much of Ofgem's approach is premised. There are also safeguards already in the licence (e.g. about how suppliers treat customers who are unable to pay their bills). And it might be more efficient and less distorting of competition to protect vulnerable customers by government-determined arrangements like the Warm Home Discount scheme for customers in fuel poverty. As Nolan suggests, there may be a case for "some form of switching service" oriented to the needs of particular sets of vulnerable customers. But the intention to "develop a successor regime to the current default tariff price cap" - which the *Strategic Narrative* suggests might even be in the form of a continuation or re-imposition of the default tariff cap - needs careful consideration.

The suggestion in this paper is that "a replacement for the price cap" should be a process rather than a specific measure – a process to investigate and if appropriate take remedial action, rather than an explicit set of constraints on prices or on price differentials.

The proposed process is based on the concept of competition as a rivalrous discovery process taking place over time. This is used, first, to assess whether, and if so where and by how much, customers (particularly vulnerable customers) might be paying excessive charges or excessive tariff differentials. If further action is called for, the process is then used to remedy the situation, either by price adjustments or by facilitating bulk or individual customer transfers to suppliers better able to offer more appropriate prices. The availability of such a process could enable removal of the tariff caps well before 2023.

The present paper begins with a brief discussion of other government-determined arrangements, an outline of Ofgem's previous position on tariff caps, and an indication of the challenges to the CMA-Ofgem characterisation of competition deficiencies in the retail market.

The main part of the paper provides some thoughts and suggestions on the process to replace the tariff caps. In summary, suppose there is a potential area of concern, involving a specified category of vulnerable customers. The proposed approach draws on Ofgem's opt-in collective switching trials. Starting first with the price changed by one particular supplier

[1] Ofgem, *Our strategic narrative for 2019-2023*, 11 July 2019, p 5 (henceforth *Strategic Narrative*).

to one narrowly defined set of vulnerable customers, it suggests a competitive bidding process to discover the lowest price at which other suppliers are willing to serve these customers, while providing whatever quality of service is deemed appropriate for such customers. Importantly, however, the process does not then simply transfer these customers from one supplier to the other via a collective switch. Rather, it uses this information to consider whether there really is a significant concern here: whether the potential savings are significant and, if so, whether the existing supplier is unwilling to match them. If both conditions hold, the process facilitates (but does not compel) the transfer of such customers by agreement between the existing and bidding suppliers. The aim, using light-handed rather than heavy-handed regulatory intervention, is to get customers to the suppliers that will service their accounts most efficiently, with acceptable quality of service standards. Only if no agreement is reached does an opt-in collective switch take place.

Next, the process envisages a period of exploration to see whether there are other vulnerable customers in a similar situation with other existing suppliers. If so, can "an acceptable price for an acceptable level of service" be secured by price reductions by the existing suppliers and/or by mutually agreed transfer of customers to new suppliers offering the lower price? Because the process takes place over time, it provides the opportunity for exploring different approaches and for learning from experience. It can also be continued, expanded, contracted or terminated as the need arises.

2. Social tariffs and the role of Government

There is of course a major question how far identifying and protecting vulnerable customers should be the role of government rather than a sector regulator. If the aim is to give such customers a better deal than they would get in a market characterised by effective competition – or for that matter the "same" deal as available to other customers that are lower cost to serve – should Government or the regulator specify which vulnerable customers are to be protected and how this should be done, and who should pay for this – taxpayers or other customers?

Ofgem's *Strategic Narrative* summarises its view of its own role.

> "How to respond to calls from stakeholders for Ofgem to be more active to protect vulnerable consumers? At present, our role is to ensure fair prices that reflect the actual costs of providing energy to disengaged consumers and those with traditional prepayment meters, and to administer efficiently the WHD and ECO schemes. Our role is not to implement social tariffs, or drive further cross-subsidy between consumer groups." (16)

To explain, the Warm Home Discount (WHD) scheme was introduced by Government to replace the various "social tariffs" offered by suppliers that were believed to be inadequate

and/or distorting of competition. The scheme provides a rebate of £140 per year to nearly two million customers (about 1.1m core and 0.8 m non-core customers) who are in or at risk of fuel poverty. The cost is paid for by higher tariffs to other customers of large and medium suppliers who are required to offer the scheme. Government is conscious that any increase in the WHD payment will lead to price increases to other customers, and presumably takes this into account in deciding on the level of the payment. However, there is still a distortion insofar as the smaller suppliers are not subject to the costs involved, which are significant. (A rough calculation suggests that for a supplier with 200,000 customers not previously in the scheme, it would cost about £2.4 million per year to participate.[2]) And this partial coverage means that some existing WHD customers may be reluctant to move to an otherwise attractive small supplier that does not offer the scheme.

There is perhaps scope to improve the availability and administration of the WHD scheme, so that the selection of those benefitting from the WHD is better tailored to help those most in need. This could provide useful additional protection for these particular customers, but is beyond the scope of the present paper.

There would be widespread agreement that it is not Ofgem's role to implement social tariffs or to implement cross-subsidies between consumer groups. Nonetheless, the possibility of such measures needs to be considered as an alternative to Ofgem taking action. It is of course for Government to decide on such social or redistributive measures and to decide who pays.

3. Ofgem's position on the tariff caps

Ofgem is concerned about a replacement for the tariff cap regime which has to end by 2023. But it could end earlier and Ofgem has to recommend whether it should. What has been Ofgem's stated position here?

In its evidence to the EMI, Ofgem explained its concerns about competition in the retail domestic market. When the EMI suggested the possibility of a safeguard tariff, Ofgem suggested three potential categories of customers.[3] It said that it would be important to establish criteria for the removal of any safeguard tariff, and suggested such a tariff could be limited to the six large energy firms.

[2] The Government reimbursed suppliers for the WHD cost for two years, via an energy rebate at £12 per customer, hence 200,000 x £12 = £2.4m.

[3] "3. Ofgem identified three potential categories of customers for a safeguard tariff. First, all customers on standard variable tariff (SVT), approximately 70% of the market. Second, vulnerable customers, who could be defined in different ways (eg cold-weather-payment customers) and might account for 15 to 20% of the market. Third, customers who have never switched from their incumbent supplier, possibly 30 to 40% of the market." Summary of response hearing with Ofgem on 30 July 2015

The EMI provisional findings included a safeguard tariff as a possible remedy. Ofgem indicated that it understood the reason for this but that a safeguard tariff was not its own preference.[4] "Our preference is for customers to be protected via effective competition rather than price regulation." (p 75) Ofgem wanted to explore "how to ensure that any safeguard tariff is tightly targeted, and is accompanied by effective measures to encourage customers to engage in the competitive market". (p 4)

When the EMI narrowed its thinking to a PPM price cap, Ofgem reiterated that "in our view, consumers' interests are best protected by effective competition rather than price regulation".[5] Ofgem repeated its concern that, "Like a safeguard tariff, the key risk of a price cap is that it may undermine competition in the market and reduce incentives for consumers to engage". (p 2) Ofgem urged that the price cap be "targeted at a narrow group of those at most risk of detriment". (p 2) It explained

> "To give some examples, the criteria used to identify those that face the greatest barriers to engagement might having limited internet access or living in rented housing, in addition to having a prepayment meter. Consumers may be more likely to suffer detriment if they have low incomes but high energy needs, and if they are particularly at risk from being in a cold home (although in some cases, the detriment suffered by some of these groups may be reduced by social programmes which are already in place, such as cold weather payments). Under this model, having a prepayment meter would not on its own be enough for a household to qualify for a regulated price cap. (p 14)

Thus Ofgem's position was that, although it was willing to advise the CMA on a tariff cap, it preferred that customers be protected via effective competition rather than by price regulation. It also preferred that any PPM price cap focus on a narrower group of vulnerable customers rather than all those on PPM tariffs, and be limited to customers still with the six large suppliers.

After the CMA introduced the PPM tariff cap, Ofgem proposed to extend this cap to certain other vulnerable customers, though this was overtaken by the default tariff cap. But as just noted, Ofgem never recommended imposing a cap on PPM tariffs generally, nor did it support imposing a tariff cap on SVTs generally – indeed it opposed this, until the Tariff Cap Act required it to introduce that cap.

[4] "We understand the rationale behind this proposal. If the CMA decides to proceed with this remedy, we will provide all the support we can in the development of its detailed design. In general, our view is that consumers' interests are best protected by effective competition." Ofgem, Response to the CMA's Provisional Findings and Notice of Possible Remedies , 5 Aug 2015, p 4.

[5] Response to the CMA's addendum to its provisional findings report and second supplemental notice of possible remedies, 13 January 2016, Remedy 22 – introducing a transitional 'safeguard price cap', p 2.

Ofgem is soon required to opine on whether conditions are in place for effective competition in the domestic retail market – that is, whether competition would be effective in the absence of the default tariff cap. Ofgem is also required to advise whether the default tariff cap should be extended for a further year or removed. These two judgements seem to be separate: Ofgem's advice on whether the tariff cap should be extended will obviously take into account its view on whether conditions are in place for effective competition, but it is also able to take into account other considerations – such as the availability of a mechanism as proposed here – that could make it appropriate not to continue the tariff cap.

Given Ofgem's previous concerns about the previous extent of competition, it is unclear what view it will take on whether conditions are now in place for effective competition. However, two things can be said. First, Ofgem's stated view to the CMA was that a tariff cap on standard variable tariffs was not appropriate: it explained why other measures were preferable. Second, whether or not retail competition was "effective" at the time that Ofgem expressed its view, there is no doubt that competition has got stronger rather than weaker since then, as indicated below. Thus, to maintain consistency, Ofgem should recommend that the default and SVT tariff cap should either be removed at the first opportunity, or at least should be significantly narrowed in scope, covering only those customers that are the most vulnerable and that are still supplied by the six large suppliers.

Ofgem further argued to the EMI that "it would be important to establish criteria for the removal of any safeguard tariff"[6] and that "a key element of its design will be a plan for exiting from the tariff at the appropriate time".[7] What then is the plan for exiting from the tariff? I have suggested elsewhere that part of the exit plan with respect to the PPM tariff cap could be a phasing out of the cap by gradually adjusting the level of the cap to the market price.[8] The Tariff Cap Act requires Ofgem to have regard to four specified considerations in setting the cap, but it does not require that these considerations be treated uniformly over time. Initially, the priority was to respond to the political imperative to cut prices considerably, and to create a strong incentive on the six large suppliers to improve their efficiency. The first has been achieved; the second is underway and unlikely to be reversed. Surely greater weight should increasingly now be placed on the other specified considerations, viz ability of suppliers to compete effectively, maintaining incentives on customers to switch suppliers, and ability of suppliers to finance their authorised activities? In the case of the PPM tariff cap, a straightforward way to do this would be gradually to increase the Headroom component, and no doubt an analogous way could be found in the case of the default tariff cap.

[6] Ofgem, Summary of response hearing with Ofgem on 30 July 2015, para 5

[7] Response to the CMA's Provisional Findings and Notice of Possible Remedies , 5 Aug 2015, p 4. Also "There is a risk that a regulated tariff becomes a permanent feature as it may be very difficult to exit from. This highlights the importance of a clear exit strategy from the start." (p 88)

[8] https://www.eprg.group.cam.ac.uk/wp-content/uploads/2019/01/S.-Littlechild_CMA-with-PS-Jan19.pdf

The process proposed in this paper could similarly be part of the exit plan from both tariff caps. Moreover, a commitment to this sort of process is not just a way of coping with the after-effects of removing the tariff cap, whenever that might be. It would also be a way of enabling an earlier removal of these tariff caps, thereby reducing the adverse effects that Ofgem and the CMA have both associated with such caps.

4. **Is the market competitive?**

What is the basis of Ofgem's concerns about the retail market, that might drive the need for a replacement for the tariff cap? In 2015 Ofgem explained why it agreed with the CMA's diagnosis.[9]

> "We strongly agree with the CMA's analysis on weak customer response and the presence of unilateral market power over inactive customers in the domestic retail market. The domestic retail market features a large number of inactive customers, an uneven distribution of such customers across suppliers, with the majority remaining with legacy suppliers, and the ability of suppliers to easily segment the market between sticky and active customers. The combination of these factors weakens competitive pressure between incumbent suppliers and creates barriers to entry and expansion for independent suppliers." (p 4)

Today, the *Strategic Narrative* reiterates the same kinds of concern.

> "The domestic energy retail market is not working well for many consumers, in a number of ways. First, the legacy of many years of a concentrated, uncompetitive retail market is widespread cost inefficiency. Second, while competition has improved in many ways in recent years, this has brought its own issues. The benefits of competition have not been evenly shared: savvy consumers have got better deals while less engaged consumers (on average less well-off and more vulnerable) have paid a penalty for their inertia." (p 14)

However, there is reason to challenge these arguments. Weak customer response? But the response is stronger in energy than in many other markets.[10] What of Ofgem's much-repeated view, that the ability to segment the market between sticky and active customers weakens competitive pressure? This fails to realise that the ability to segment such customers is precisely what enabled effective competition in the first place. If suppliers had to charge the same price to all customers then competition would have been much less

[9] Ofgem, Response to the CMA's Provisional Findings and Notice of Possible Remedies , 5 Aug 2015

[10] After a survey in March 2019, "nearly half (48%) of those surveyed said they have switched energy supplier in the last four years – significantly higher than those who said they had switched home insurance (35%), broadband (31%), telephone provider (24%) and bank (14%)". https://www.energyswitchguarantee.com/latest-news/nearly-half-of-energy-consumers-have-switched-according-to-new-survey/

effective. Ofgem's non-discrimination policy which economists and the CMA found to have reduced competition after 2009, amply demonstrated this.

What are these feared "barriers to entry and expansion for independent suppliers"? Competitors flocked into the market, and even with about a dozen entrants withdrawing in the last year or so there are still over 60 suppliers in the market, about double the level at the time of the EMI. Ofgem's retail market indicators show that independent suppliers have doubled their market share in the three years since the time of the EMI. In the electricity sector, the Small suppliers in aggregate now have the same market share (8%) as the smallest of the six Large suppliers, and the Medium suppliers in aggregate have nearly the same market share (18%) as the largest of the six Large suppliers (19%). In gas, the Small suppliers in aggregate are larger than two of the Large suppliers and the Medium suppliers in aggregate are well ahead of all Large suppliers except British Gas. For PPM customers, two independents suppliers (Ovo and Utilita) are second and third largest suppliers, ahead of five of the Large suppliers.

Widespread cost inefficiency? But there has not been adequate consideration of differences in customer mix that mean cost to serve is higher for the Large suppliers.[11] Moreover, at any point in time there are more and less efficient suppliers in any competitive market. No evidence has been presented that the extent of inefficiency is greater in this market than in any other market, or is being removed less quickly than in other markets. Savvy consumers have got better deals while less engaged consumers have got less attractive deals? So what's new? That is true in any competitive market. Less engaged consumers are on average less well-off and more vulnerable? Surely that too is true of any newly competitive market, and understandably so when there are risks in moving from a known supplier to an unknown one.

Because active consumers find better deals than less active customers, Ofgem has described this as a two-tier market.[12] But in reality this is a multi-tier market, with a wide range of prices as well as a wide range of product variants and a wide range of costs incurred by suppliers in offering them. Independent economists have explained that price differentials may indicate effective rather than ineffective competition.[13] Former energy regulators have argued that the market process is indeed competitive.[14] See also the evidence of all the

[11] See Baringa, *Creating a level playing field in the GB retail energy market*, a report for Scottish Power, 22 May 2018.

[12] E.g. Ofgem, *Developing a framework for assessing whether conditions are in place for effective competition in domestic supply contracts*, Discussion Paper, 29 May 2019, Introductory context.

[13] C.f. "Price differentials are an inherent part of almost all real-world markets …", C Waddams Price, "Back to the Future? Regulating Residential Energy Markets", *International Journal of the Economics of Business*, 25:1, 147-155, at p 154.

[14] E.g. most recently Stephen Littlechild et al, Response to Ofgem on effective competition, at https://www.eprg.group.cam.ac.uk/letter-from-s-littlechild-to-ofgem-on-effective-competition-9-july-2019/

large suppliers throughout the EMI. There is thus an abundance of analysis, argument and evidence challenging the CMA/Ofgem view of the retail market.

The fact is that real competitive retail energy markets, populated by real customers, look like the GB market, not like the theoretical concepts of perfect competition. And those few retail markets where the switching rate is even higher than in GB, as in Victoria in Australia, don't look any more like perfect competition. Customers' preferences differ significantly, one from another, and significant price differentials are normal, not abnormal. So, before any serious regulatory intervention can be justified on the grounds that competition is not working, a stronger case needs to be made than has been made hitherto.

5. Fair prices?

The *Strategic Narrative* makes over a dozen references to fairness. Set aside those references to other parts of the sector that are not directly relevant here.[15] In the retail market Ofgem aims to achieve "fair treatment" by "Using targeted interventions for a fairer market: we will intervene to provide backstop protections – such as the default tariff price cap – to ensure all consumers pay an acceptable price for an acceptable level of service". (p 7) Also, the default tariff cap "ensures loyal consumers pay a fair price that reflects efficient costs" (p 14). And as cited earlier, Ofgem says "our role is to ensure fair prices that reflect the actual costs of providing energy to disengaged consumers and those with traditional prepayment meters". (p 16)

What then does a fair price mean? In this one single document it is variously defined as "an acceptable price for an acceptable level of service", as a "price that reflects efficient costs", and as a price "that reflect[s] the actual costs of providing energy". This ambiguity is not the only disconcerting feature. Achieving a fair price is said to be Ofgem's aim and role. Yet not long ago Ofgem explained to the EMI that, while it was concerned to ensure fair conduct, it was explicitly *not* "seeking to mandate fair tariffs", and "the concept of fairness" did *not* apply to suppliers' pricing strategies.[16] Does this mean that Ofgem is reversing its previous policy, and now *is* prescribing or requiring fair tariffs? Or is this an example of the new

[15] For example, references to the Secretary of State's principle that "consumers of all types should pay a fair share of system costs" (p 11) and the discussion of a "fair charging system" for network services (p 18). Note that the "overarching aims within the wholesale energy market" include "to ensure that the wholesale markets are fair" (p 19) where fair means that "participants can access the market on equal terms". The latter is broadly true in the retail market except insofar as smaller suppliers are exempt from various costly social and environmental obligations (such as WHD) placed on other suppliers.

[16] "It [Ofgem] was not seeking to mandate fair tariffs in the market but it did have rules for fair behaviour of suppliers under its Standards of Conduct rule. The concept of fairness and the Standards of Conduct applied to the conduct of suppliers as opposed to their pricing strategies." Summary of hearing with Ofgem on 31 March 2015, para 23.

"more agile way of working", where the team that knew what the previous policy was has been moved on to another area?

If, after the withdrawal of the tariff cap(s), Ofgem is going to invoke or acknowledge the concept of fairness in pricing (perhaps because politicians and the media will continue to do so), then it needs some way to make this operational. It is not sufficient to introduce a licence condition saying that suppliers should set fair prices. Ofgem needs to be able to investigate and demonstrate that, according to some criterion, the prices being charged – let us say by some suppliers to a subset of vulnerable customers – are in some sense excessive in relation to cost. Moreover, Ofgem then needs to be able to do something about this.

This raises two questions. First, for any specific allegation or suspicion of excessive prices to a particular set of vulnerable customers, how to ascertain what appropriate prices would be? Second, if the observed prices are held to be actually or potentially excessive, to a significant extent, what then to do about them, in a market where there is no longer a PPM or default tariff cap? Reimpose a cap on that tariff? Or is there a better alternative?

6. Possible options for Ofgem actions

One suggestion might be for Ofgem to define a set of vulnerable customers then to impose a "narrow" cap on the tariffs to such customers – that is, a cap that is narrower than the present PPM and default tariff caps. This may seem to be administratively straightforward, given that there are existing tariff caps, and it would constitute a tangible demonstration of the protection provided. But there are numerous disadvantages. One is the challenge of working out whether the present prices are unfair (however defined) or excessive, which requires identifying the cost of serving this particular set of customers. Another is the possibility that the cap might be set too tight because of uncertainty about this cost, the difficult of forecasting the future, and the pressure to deliver a tangible benefit (a possibility that is now recognised to have been a reality in the case of the PPM tariff cap). Then there are the distortions created by any price cap, including the possibility that suppliers will try to avoid serving such customers or will cut back on other measures to help vulnerable customers (as noted at a recent Consumer Vulnerability Conference[17]). It is possible that introducing a cap will bring pressure to extend the scope of the cap. And finally there is the difficulty, highlighted by Ofgem to the EMI, of ever bringing such a price cap to an end.

Another option suggested recently at the same Consumer Vulnerability Conference is the appointment of a single supplier for specified vulnerable customers. A speaker from one of the suppliers asked "Is there a group of customers – for example, those that are disengaged,

[17] "Price cap 'is leading to erosion of support for vulnerable customers'", James Wallin, *Utility Week*, 28 June 2019.

pension credit customers, those with low educational attainment or learning difficulties – who ought to be taken out of the market altogether and placed with one supplier who is charged with safeguarding those customers so we no longer attempt to throw them into the mix?"

Assuming such vulnerable customers are identified, this poses a number of questions. How to ascertain whether their present prices are unfair or excessive? Which (existing or new) supplier is to be given this new responsibility for serving them? And how it should set its tariff(s)? Then, how are customers to be transferred to the new supplier? Are they simply to be taken from their existing supplier or do they have a say in the matter? Is any compensation payable to the existing suppliers, who have had their customers taken away? Is it as efficient for one supplier to serve a set of vulnerable customers as for several suppliers to do so? And does this tend to lose the advantages (in terms of efficiency and innovation) of several competing suppliers?

A less intrusive option – perhaps what Dermot Nolan had in mind as "some form of switching service" - is that vulnerable customers could be given advice and assistance tailored to their circumstances, to enable them better to engage in the market, or to have someone engage in the market on their behalf. There could well be widespread support for this. Questions there include the cost and feasibility of providing such assistance, and how the advisers will know whether an alternative supplier, which might be offering a cheaper tariff than the existing supplier, would provide better or adequate service for this particular type of vulnerable customer.

It might be argued that, rather than advise customers to switch supplier, the right solution is to ensure that the existing suppliers offer "fair prices that reflect the actual costs" in the first place, hence a more proactive solution is required than simply providing advice. Of course, this again raises the question of how to identify the price levels that would be "fair" what the "actual costs" would be, and then how to ensure that existing suppliers set prices at such levels if they are not indeed already doing so.

7. Customer engagement and collective switch trials

Do Ofgem's recent customer engagement trials address any of these issues, or shed any light on what approach might be taken?

The EMI Final Report identified a problem of "weak customer response" in the domestic retail energy market and recommended that Ofgem establish a programme to provide customers with information to prompt them to engage in the market. It placed emphasis on randomised control trials to see what worked and what did not, and recommended a new licence condition to require suppliers to participate. Ofgem has engaged in a series of such

trials.[18] Customers were typically given the initial option to opt-out of receiving information and offers, though in practice only a negligible proportion of customers did so. Then, those customers that wished to accept the offer from another supplier were required to opt-in to select it and to implement a switch.

The early trials found that information provided (in various ways) increased switching by a few percentage points compared to a control group. But the last reported trial, namely the Collective Switch trial reported in August 2018, involving 50,000 customers of Scottish Power, found that 22.4% of participants opted to change their energy tariff (with the same or another supplier). This was an order of magnitude higher than the 2.6% changing tariff in the control group. This trial included the offer of an exclusive tariff negotiated by Energyhelpline at the request of Ofgem. Customers were notified of personalised calculations (made by Energyhelpline) of savings under the new tariff. Energyhelpline also provided advice to customers that wished to consider other suppliers. Results of a subsequent Autumn 2018 trial, involving 100,000 customers of nPower, have not yet been reported.

There has been some interest in opt-out switching, whereby customers are switched to a new supplier offering better terms unless they opt-out of doing so.[19] This approach has been widely used in the US states of Ohio and, later, Illinois, where some municipalities negotiated a supplier then switched all residents unless they opted out.[20] However, this was only possible where residents of the community had previously voted explicitly to adopt this approach.

In practice, a relatively small proportion of customers typically opt-out (or for that matter opt-in) to any proposal. So an opt-out switch is tantamount to transferring the majority of the customers involved to another supplier. It might be argued that this is in the interests of the customers involved. But, in a UK context, it would seem tantamount to regulatory expropriation of the assets (customers) of a supplier, and the amounts involved could be significant, as illustrated shortly. Would it be good regulatory practice for Ofgem to direct a series of suppliers to, in effect, transfer a proportion of their assets (customers) to other suppliers? As also explained shortly, outside of the trials recommended by CMA to increase customer engagement, it is not clear that Ofgem has power to do this, and it would not

[18] For details and discussion see Stephen Littlechild, "Ofgem's collective switching trial and possible application in New Zealand", 19 March 2019, available at https://www.eprg.group.cam.ac.uk/report-ofgems-collective-switching-trial-and-possible-application-in-new-zealand-by-s-littlechild/ (henceforth referenced as *New Zealand*)

[19] Deller, D., Bernal, P., Hviid, M. and Waddams Price, C, "Collective Switching and Possible Uses of the Disengaged Consumer Database", University of East Anglia, Centre for Competition Policy, 2017.

[20] Stephen Littlechild, "Municipal aggregation and retail competition in the Ohio energy sector", *Journal of Regulatory Economics*, vol. 34(2), pp 164-194.

seem conducive to regulatory stability and investment in the industry. For that reason, opt-out switches are not considered further in this paper.

Since the Ofgem trials have involved opt-in rather than opt-out collective switches, could such an opt-in collective switching approach be applied to vulnerable customers? It could potentially achieve savings for them and familiarise them with the process of changing supplier. There are, however, some reservations.

The CMA was concerned that requiring suppliers to advertise competitors' tariffs could encourage customers to remain disengaged in future. As yet, evidence on this is lacking.

Is it actually feasible to offer collective switching plus personal advice to all the customers for whom this might be recommended? The EMI estimated that 10 million customers were disengaged. If collective switch exercises were run every 3 months, each involving 100,000 customers, then it would take 25 years to get round to all these disengaged customers. The burdens on regulatory agencies and on suppliers need to be considered, as does the ratio of costs and benefits. The Government's Cheaper Together policy of encouraging collective switching schemes cost nearly twice as much as the benefits secured from switching.[21] Also important is whether this is a one-off project or a continuing exercise. If it starts, when does it stop? And what about the majority of customers that do not get involved and therefore stay with the existing supplier on existing terms, even though better terms are apparently available elsewhere?

Suppliers have various concerns, including about potential violation of data privacy laws. Trials are costly, and require suppliers to invite their customers to leave. Although opt-in switches do not involve almost all customers leaving, the Autumn 2018 trial did involve a significant proportion of the customers leaving, and was estimated to cost the supplier £30 million in lost revenues. In its own legal challenge to the Ofgem trial, nPower argued that the licence condition (SLC32A) recommended by the CMA "is a measure to trial consumer engagement measures to inform future policy interventions, it [is] not a regulatory tool to achieve a (direct) result". Furthermore, Article 1 of the first protocol to the Human Rights Act was engaged.[22] So regulatory expropriation can indeed be an issue, and legal challenges to the implementation of policy cannot be ruled out. Certainly it cannot be assumed that Ofgem has the power to enforce either opt-in or opt-out collective switches once the trials recommended by the CMA have been completed.

Reputation and customer loyalty are important. A regulator facilitating the transfer of customers to another supplier would need to consider, in addition, the quality of service,

[21] *Helping Customers Switch, Collective Switching and Beyond*, DECC, 2013.

[22] "Article 1 Protection of property. Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law." (See Littlechild, *New Zealand*, paras 90, 104)

reputation, and likely future prices that would be charged by this new supplier. If customers value service and good performance over time, how is this best identified? There is limited evidence in the trials to date that this was a consideration in proposing alternative suppliers. In one case a proposed supplier had the highest complaints ratio ever recorded, and went out of business some 18 months after being put forward in an Ofgem trial.

The impact on the market needs to be considered. For example, a large scale transfer of a particular type of customer might have an impact on prices in the market. For some suppliers, fewer customers on standard variable tariffs could increase the level of those tariffs necessary to cover total costs, and a shorter duration of stay could reduce the viability of offering lower prices to attract new customers. How to reconcile facilitating large-scale collective switches for disengaged customers with encouraging customer loyalty to high quality and trusted suppliers? And is it appropriate for Ofgem to organise bulk collective switches that could favour suppliers able to absorb large quantities of customers at the expense of smaller or newer suppliers that are not able to do so?

8. **Finding a way through**

As explained, Ofgem's aim is to eliminate or reduce "unfair price differentials" that are not cost-reflective, particularly as they impact on vulnerable customers. Against this, it has been argued that the competitive retail market is in fact working well, and that there are many potential explanations for observed price differentials. Different prices may reflect different products, or different costs to serve different kinds of customers.

How to tell whether particular observed price differentials are fair or unfair, cost reflective or not? And if it is accepted that some regulatory action should be taken to protect vulnerable customers, not least to enable the removal of the default and PPM tariff caps that presently cover some 60% of tariffs, what should that action be? As noted, various possible remedies - narrow price caps, a single designated supplier to such customers, advice to such customers, and collective switches - all have limitations.

Economics textbooks find it helpful to focus on perfect competition. But this is a purely hypothetical construct that might be useful for certain abstract purposes (e.g. analysing the effect on prices of a shift in the demand for or supply of a certain commodity). More realistically, competition may be seen as a rivalrous discovery process taking place over time.[23] It is a process of discovering which suppliers are best able to identify and meet the needs of different sets of customers, and of discovering the most efficient ways to supply

[23] This is essentially the definition of competition set out in the original Competition Commission Guidelines, and subsequently adopted by the CMA, except that the Competition Commission failed to include the word 'discovery' and in revising the Guidelines omitted 'taking place over time' on the grounds that this could be taken for granted.

them, and at what prices. Amongst other things, competition should reveal, over time, whether there are different costs to serve different kinds of customers.

An approach informed by Ofgem's switching trials has the potential to shed light on whether observed prices are cost-reflective since it uses competition by inviting bids to supply particular customers, which can be compared against the observed prices they are paying. However, as noted, the switching approach has several limitations of its own, notably with respect to time and cost involved, expropriation of a supplier's existing customers, the possibility of non-engagement by the majority of customers involved, and uncertainty about future quality of service.

The proposal here is to adapt Ofgem's recent opt-in collective switching approach to address these limitations to that approach.

- First, the process can be used to inform the assessment of whether, in any particular case, there is or is not a significant problem of "unfair prices" that do not reflect costs.
- Second, to make the process practicable within a reasonable time, the number of vulnerable customers involved needs to be at least one or two orders of magnitude fewer than the 10 million disengaged customers envisaged by the EMI.
- Third, there needs to be a way by which the existing suppliers can gain from the transfer of their customers, rather than have them expropriated. This can be achieved by facilitating the option for the existing supplier to transfer these customers to a new supplier if a price can be mutually agreed, as in the sale of any part of a business to another company.
- Fourth, such a transfer would mean that almost all the customers in question would secure better terms (rather than only the customers who might later opt to switch).
- Fifth, the bidding process would be required to have particular regard to obligations to provide quality of service appropriate to these particular vulnerable customers.

This process offers a prospect of further insight beyond the protection of these particular vulnerable customers. There is ongoing debate whether the six large suppliers are the most efficient suppliers of energy to less engaged customers and whether they need prices as high as the Standard Variable Tariffs (SVTs) that the large suppliers have traditionally set. The large suppliers generally claim that, as their lower cost-to-serve customers are attracted to smaller suppliers, their remaining customers are relatively (and increasingly) high cost-to-serve. But are there other newer suppliers that are able and willing to provide just as good or better service for these vulnerable customers, on a more efficient basis and at a lower price? This is not at all obvious. We do not know whether other suppliers would be interested in serving such customers, if so whether they could do it at a higher or lower cost than the existing suppliers, and whether they would provide better or worse customer service in doing so.

If the proposed approach can shed light on this question with respect to a narrowly defined set of vulnerable customers, it will also inform understanding and policy with respect to the prices paid by less engaged customers generally.

9. Features of the proposed process to replace the price cap

With the above concepts in mind, this draft proposal for replacing the price cap has several distinctive features.

First, the aim is to establish competitive market-based prices for serving specified categories of vulnerable customers rather than regulatory-determined prices. This is important because, as explained, the costs of serving different categories of vulnerable customers have been much disputed.[24] It is therefore important to discover what would be reasonable and viable competitive market-based tariffs on which (enough) suppliers would be keen to supply different types of vulnerable customers.

Second, in order to establish such prices, the process invites suppliers to bid to serve specified sets of vulnerable customers. In doing so it uses a similar process to the one that Ofgem has been using for its opt-in customer engagement trials. Indeed, the suggested process may provide a sense of future direction for this approach, and also an awareness of some of the potential problems (not least, associated with the time and cost involved, and the concerns about potential expropriation).

Third, consistent with the focus on vulnerable customers, the process takes particular account (both at the bidding stage and afterwards) of quality of service considerations. These would be tailored to those considerations of greatest importance and relevance to the particular category of vulnerable customers involved.

Fourth, it is possible that, in the light of bids to serve the identified vulnerable customers, Ofgem may conclude that prices presently offered are not "unfair" – that is, they are not significantly out of line with what other potential suppliers are able to offer in the competitive market. In this case, there may be no need to continue with the process. Attention can turn, if needed, to other potential vulnerable customers.

[24] Ofgem itself acknowledged this. "Ofgem thought it would be possible to model wholesale costs for the tariff despite the hedging strategies employed by energy firms. The most difficult part would be identifying suppliers' operational costs." Summary of response hearing with Ofgem on 30 July 2015, para 8. Subsequent experience with the tariff caps has justified Ofgem's apprehensions. For recent evidence on different costs, see the Baringa report at fn 11 above.

Fifth, in order to ensure that the proposed process is as effective and speedy as possible, and so as not to expropriate the value of loyal customers to existing suppliers, the proposal provides the opportunity, before the collective switch takes place, for suppliers themselves to transfer tranches of customers to other suppliers, on a negotiated commercial basis, while still enabling vulnerable customers to exercise choice of supplier.

Sixth, if the process continues then, consistent with the Ofgem trials, the process proposes that customers have to opt-in to the selected supplier and bid price rather than opt-out. This is for two main reasons: to give greater weight to active customer choice and to avoid simply expropriating customers from present suppliers. Long-standing customers are, or have been or could be, valuable assets to those suppliers that have served them over a long period of time. Increasingly, today's medium and small suppliers will be building up loyal customers. Customer loyalty (for the right reasons) is a valuable asset to be encouraged rather than destroyed.

Seventh, again consistent with the most recent Ofgem trials, the process provides personal advice and assistance to the vulnerable customers, to enable them to make informed decisions about their future supplier. This means that, after the bid process, customers are able to choose not only between the present supplier and the winning supplier, but also between other suppliers that the advice line might suggest, and indeed between yet other suppliers that the customers themselves might identify, explore and decide upon. It is, nonetheless, important to ascertain the cost of providing such advice, and to ensure that this cost is not disproportionate to the benefits that the process yields.

10. Details of the proposed bidding process for protecting vulnerable customers

In more detail, the proposed process is as follows. This outline is for discussion rather than constituting the definitive and only possible application of it. And, importantly, it would need to be implemented consistently with General Data Protection Regulation for those customers that have opted out of marketing.

1. Define the first set of vulnerable customers for whom continuing protection may need to be provided after removal of the tariff cap.

In submissions to the EMI, Ofgem suggested the possibility of defining vulnerable customers as those in receipt of cold weather payments. There were an estimated 3.8 million eligible recipients at the start of season 2018-19. An estimated 1.6 million of these claimants were in receipt of Pension Credit.[25]

[25] https://www.gov.uk/government/publications/cold-weather-payment-estimates-2018-to-2019/background-and-methodology-cold-weather-payment-estimates

Another possibility might be to define the most vulnerable customers as those on the WHD core scheme who are still with their vesting suppliers. There are now about 1.1 m core WHD customers (plus about 800,000 non-core WHD customers). Admittedly these are by no means the only customers that might be regarded as vulnerable, and arguably some of the Broader group of non-core WHD customers are more vulnerable in some respects. There are also customers that are entitled to the benefits which would make them eligible for the WHD but for various reasons don't claim them. And increasingly regulators are seeking to take account also of customers deemed vulnerable in other utility services. Nonetheless, WHD core customers might seem a convenient and well-defined group of customers with which to illustrate the process. Moreover, this would avoid the complications associated with the costs to suppliers of accommodating non-core customers.

However, there are (at least) three reasons why cold-weather payment and WHD customers do not seem the best place to start. First, it has not been alleged that these customers per se have suffered "unfair prices". Second, the costs and other implications and complications of bidding for some millions of these customers seem likely to disadvantage smaller suppliers. Third, the number of such customers seems prohibitive for more practical reasons, as now explained.

2. Consider carefully the number of customers in the first exercise

Would it be feasible to run the proposed process for between one and four million vulnerable customers? Ofgem's latest and largest Autumn 2018 collective switch trial involved 100,000 customers. Bids were presumably made, although it is not yet public how many suppliers were able and willing to take on 100,000 customers. Even if 1.1m WHD customers could be dealt with in 11 tranches of 100k customers each, and even if tranches were scheduled each month, it would take over a year to complete them all.

For several reasons, one million customers seems too many for this approach. Tranches of 100,000 customers will preclude smaller suppliers from bidding to supply them. Smaller tranches would allow more suppliers to participate in the process. The first collective switch trial involved 50,000 customers, and before that the Cheaper Market Offers Letter trial involved two samples of 75,000 customers. But the Check Your Energy Deal trial involved 10,000 customers and the initial Database trial only 2400 customers. One month between auctions would make it difficult for suppliers to participate in successive auctions. Perhaps two to three months between auctions would be more practicable. There is also a question whether sites like Energyhelpline could provide continued assistance for one million customers in a year.

Suppose an aim initially is to enable maximum participation by potential new suppliers but also to finish the auction process within a year or so. Rather than about a million customers,

does this imply something more like five auctions of about 20,000 customers each, say about 100,000 vulnerable customers in total?

But is it actually necessary or sensible to start the exercise with as many 100,000 vulnerable customers? To get a better sense of how the approach is likely to work, and to iron out initial wrinkles, why not start with, say, three auctions of 10,000 vulnerable customers each? The aim would not be to address all the problems of "unfair prices" across the board, but to try to understand the prices paid by some narrowly defined sets of vulnerable customers, where there is particular concern about price differentials but who may - or may not - be considerably more costly to serve than the average customer, or the average engaged customer. The initial priority is to ascertain whether the prices they presently pay are significantly above what other suppliers would be willing to offer, or are broadly in line with that?

As explained shortly, it is possible that experience with the first auction will render later auctions unnecessary or enable them to be replaced by commercial negotiations.

It is beyond the scope of this paper to specify which set(s) of vulnerable customers should be chosen. It is suggested, however, that customers who have already switched one supplier or other have demonstrated some ability to engage in the market. They may already be on better tariffs than the SVTs of the large suppliers. Hence such customers are no longer first priority for further assistance and protection. This means, as Ofgem envisaged, that the priority vulnerable customers will be electricity customers of the five successor electricity suppliers and (if they take gas) gas customers of British Gas Centrica. (Dual fuel customers of one of these suppliers will not be a priority since they will already have switched one of the fuel suppliers.)

If the proposed process is potentially attractive to customers, then a wider set of vulnerable or even non-vulnerable customers might like to benefit from it. However, the process is costly, and (even with the modified process) can arguably involve some element of expropriation from existing suppliers. In the first instance, at least, it should therefore be limited to the most vulnerable customers, with other forms of assistance being more appropriate for other customers.

3. Put out to auction the opportunity to supply the first tranche of vulnerable customers.

These customers would be with an identified one of the six large suppliers. Some reason would have been given as to why they might not be on "fair prices". The characteristics of these customers would be made available in general terms to potential suppliers so as to

inform their bids. As far as possible, the host large supplier should not have any preferred knowledge of their characteristics as a group.

There is, however, a legal question to be considered here. In the event that an existing supplier would prefer not to cooperate, does Ofgem have the power to require a supplier to provide such details of a tranche of its customers? The aim is no longer a trial of methods to encourage customer engagement, hence would presumably not be covered by the new licence condition SLC32A relating to that. But Ofgem does have other information-gathering powers, including with a view to making a reference to the CMA. In principle this might be necessary if a particular price were found to be excessive and if the suppliers concerned were not prepared to take remedial action, although the aim of the proposed process is to resolve such issues voluntarily.

The potential new supplier would be bidding to supply such of these customers as agree to switch supplier (on an opt-in basis), at this bid price, for a specified period of time. Two or three years seems a reasonable period in the first instance. A shorter period could be disruptive for customers not used to changing supplier, and might invite suppliers to bid on a loss-leader basis, in order to raise tariffs later. A longer period would go beyond what customers normally choose, the hedging risks might increase the tariff unduly, and the opportunity to take remedial action if there were a problem would be deferred. For convenience of exposition, a period of two years is assumed here.

Ofgem would then select the preferred supplier, normally at the lowest two- year fixed term tariff offered, although Ofgem would also take into account the following quality of service considerations. (It is also for consideration whether the nature of the bids might be more sophisticated than a single price bid.)

4. There would be minimum quality of service obligations on bidders, to provide service appropriate to the needs of the vulnerable customers.

There is an important issue to be decided with respect to quality of service. Is the aim to secure better or more appropriate quality of service, more suited to particular types of vulnerable customers, than is commonly available in the market? Or is the aim to ensure that appropriate customer service standards that are presently typically available to such customers continue to be provided by the potential new suppliers, who might presently not be providing such service because they do not have such customers?

The first aim is not to be ruled out, but does not seem appropriate for the present exercise. So, the obligations might include, for example, access to appropriately trained customer service personnel rather than reliance on chat rooms, and perhaps maximum waiting times

to respond to and substantially answer telephone calls, which might reasonably be expected of all suppliers to such customers, and which are believed to be provided at present.

It would be open to suppliers to offer higher quality service and to seek to differentiate their product from that of other suppliers. And in choosing the preferred supplier, Ofgem would be able to take into account differences in each supplier's previous or proposed quality of customer service. (Ofgem might wish to take advice from relevant customer services sources here.)

5. Consider whether the bids are sufficiently different from prices presently offered to warrant a finding that present prices are excessive.

The proposed process would be costly if applied in the same way to all tranches of vulnerable customers. However, there is no point in continuing with it if there turns out not to be a serious problem that needs addressing – indeed, there is every reason not to. So there needs to be an examination of the numbers and levels of bids offered, and a comparison with the level of prices currently charged by existing supplier and other existing suppliers. If there is no significant difference, other existing suppliers can be stood down. Attention can turn, if needed, to other potential vulnerable customers. This would also suggest a reappraisal of the assumption that there are excessive price differentials, and of the need for further widespread investigation and protection. But if there are significant differences, there may be reason to continue.

6. Facilitate voluntary transfers of customers between suppliers

Assuming that a new supplier offers a significantly lower price than the existing supplier, it may not be most efficient to require all the 10,000 or so customers to go through the process of choosing a new supplier. Accordingly, before the preferred offer is put to customers, the existing large supplier would have the option to negotiate a voluntary transfer of that whole tranche of customers to the preferred supplier, at terms to be agreed between the two suppliers. The acquiring supplier would then take on the obligation to supply these customers at the winning bid price, and on the proposed quality of service terms, for the assumed two years. These customers would become customers of this new supplier and would stay with that supplier until such time as they chose to move to another supplier.

What would be the incentive on these two suppliers to negotiate a deal rather than let the customers choose? For the existing (selling) supplier there is the prospect of compensation for losing a segment of its customer base. For the new (acquiring) supplier there is the prospect of acquiring nearly 100% of the customers rather than, say, a quarter or less of that number, plus the savings from not having to compensate the advising agency (such as

Energyhelpline) on a per customer basis, as is understood to have been the case in the Ofgem collective switch trials.

7. Extend this option to other suppliers

If such a deal is not agreed between the existing large supplier and the preferred supplier, the existing large supplier would have the option to negotiate a voluntary sale of the same whole tranche of WHD customers to any other supplier, provided this other supplier adopts the terms as to price and quality of service specified in the preferred bid. (Thus, the preferred supplier in effect has right of first refusal.)

The purpose of such block transfers of customers is not to prevent individual customers exercising choice. Indeed, all customers retain the right at all times to choose their own supplier. Rather, the purpose is to effect the quickest and most efficient mutually agreed transfer of customers between suppliers where it seems that a new supplier can provide better and/or more efficient and lower priced service. And it also provides the option to avoid the expropriation of loyal customers of the existing supplier.

8. Consider a customer opt-out provision during the block transfer

It is for consideration whether to include an explicit customer opt-out provision in the event of a mutually agreed block transfer of customers. On the one hand, there is arguably no need insofar as it is common practice for companies and their customers to be sold en bloc to other companies, including in the domestic energy supply market. So no new precedent would be established here in not providing explicitly for opt-out. On the other hand, in this as in any other sale of a company, there is nothing to prevent a customer who does not wish to join the new supplier from simply leaving. Whether that customer could stay with the existing large supplier depends on whether that supplier proposes to continue in the business of supplying such customers. That is a commercial matter for that supplier (subject to whatever Ofgem regulations might apply). Again, advice to the vulnerable customers could be provided as required.

9. Allow the existing supplier to propose a new tariff

If a deal between suppliers is not agreed, it seems appropriate for the existing large supplier to have the option to offer a new two-year tariff for these vulnerable customers in reaction to the preferred supplier's bid. Admittedly, from a competition perspective there are pros and cons. For example, in New Zealand there is active discussion about the merits or otherwise of 'win-back' pricing. But that is in the context of win-back pricing tailored to particular customers individually. In the present situation the question is whether a new

tariff can be offered for a whole class of vulnerable customers (perhaps 10,000 of them), rather just for a few individual customers. This surely offers benefits to customers.

10. Consider the implications of a deal or a new tariff for other tranches of customers

If the existing supplier has agreed a block transfer of this tranche of its customers to a new supplier, this brings an end to the present process. The implication is that the bid price is, in popular terms, a "fair price", consistent with a competitive market, and the previous price was not. In this event, it would seem appropriate for Ofgem to put this point to other existing suppliers of the remaining tranches of customers. Is it now sensible to go through another set of auction processes, that could yield the same outcome? Or would it be more sensible for the existing suppliers either to cut their prices towards this newly established level, or alternatively to agree to transfer their customers to another supplier that will henceforth supply at approximately the newly established rate?

It is conceivable that the existing supplier might lower its tariff to match, or nearly match, that of the new bid. If so, and there is no obvious benefit from continuing the transfer process, then again it could be halted. This would be different from the previous situation where the process was halted because the new bids were not significantly different from the original prices. There, the new bids in effect justified the existing prices as "fair". Here, the new bid has, in effect, identified an "unfair cost differential" but the existing supplier has moved to eliminate it. So in this case Ofgem would presumably wish to approach other existing suppliers and invite them to adjust their existing prices. It would be for Ofgem to judge whether these adjustments were sufficient and whether the process should continue or be abandoned.

11. Consider the options legally available

Now consider the possibility that the preferred supplier has offered a significantly lower price to supply this particular tranche of vulnerable customers than the existing supplier presently offers. And, the existing supplier has not offered a price reduction that Ofgem considers adequate and has not reached a deal to transfer these customers to an alternative supplier willing to supply these customers at this price.

Ofgem will now wish to consider whether the case is sufficiently serious to take further steps. If so, it will need to consider whether it has the legal power to put this offer to the customers in question of the existing supplier, and to require the existing supplier to participate in this process. (In practice, of course, it will have considered such legal questions earlier.) If Ofgem considers that it does not have power to do this, then it will need to consider whether to ask the CMA for power to do so. Assume, for purposes of explaining the last part of the process, that Ofgem does indeed have this power, or that

Ofgem's wish to do this is not challenged by the existing supplier, or that the CMA has granted Ofgem the power after a licence modification reference.

12. Put the offer to customers

Assuming that Ofgem proceeds with the process, customers in the identified tranche are now sent a letter (it is for consideration who should send it) explaining that (after an Ofgem-organised auction) the preferred supplier has submitted a lower priced bid to serve these customers (with due regard for quality of service). These customers now have the following three options: i) to transfer to the preferred supplier at the bid price, ii) to transfer to any other supplier in the market, with or without customer advice and assistance (e.g. as provided by Energyhelpline in the recent Ofgem collective switch trial), or iii) to stay with the existing large supplier, either on that supplier's new two-year tariff or on some other existing tariff.

It is possible that a proportion of customers will opt to do nothing, and will therefore remain with the existing large supplier, either by conscious choice or by default. It is not clear that these customers themselves will regard this as disadvantageous. However, it emphasises the importance of ensuring that these vulnerable customers are properly advised during the process.

13. Appraise the process and consider whether to repeat it

Ofgem will again wish to consider the lessons of the process. It will decide whether to repeat it for the remaining tranches of these vulnerable customers or (as indicated above) to suggest to existing and present suppliers that they consider short-cutting the process. This might be done either by cutting existing prices or by negotiating transfers to suppliers able to offer significantly lower prices.

With experience it might be possible to speed up the later tranches. Alternatively, if a large number of customers is involved, it might be possible to agree the tariffs and transfers in a short period of time, then to phase the actual transfers of customers over a longer period of time.

Although in principle it might be possible to hold the auction process for all identified customers at a single point in time, phasing the auction process over time will allow all market participants – suppliers and customers - to observe the prices and preferences being established in the market, and to respond to this information by modifying accordingly their bid prices, or their quality of service offerings, or their decisions as to acceptance. It will also enable acquiring suppliers to digest early tranches of customers and come back for more. And, of course, it provides valuable information for ongoing use by Ofgem.

14. Consider the implications of the whole experience

The outcome of this process is protection for the specified vulnerable customers by securing that their prices are determined in an effectively competitive market. This may involve reassurance that their previous prices are indeed competitive, or the substitution of lower prices as a result of a competitive auction and/or by commercial negotiation. Intrusive regulation is minimised. There would also be a gradual shift of vulnerable customers to those suppliers that can most efficiently serve them.

It is for discussion what happens after this initial process, and after the expiration of the initial tariff contract period (say two or three years). The initial bid specifications might include a requirement that there should be no sudden or unreasonable tariff increase at the end of the initial contract period. However, allowance would have to be made for changes in underlying costs of supply (including a reasonable margin for the supplier). The initial bid price might include an indication of the basis on which these customers would be supplied thereafter. Perhaps there should be some regulatory interest in the subsequent tariffs, not necessarily requiring "regulatory approval" but rather to satisfy Ofgem and other interested parties that the original bid was not simply a means of acquiring customers that could thereafter be exploited.

For those customers that chose different suppliers, it might henceforth be presumed that they are sufficiently engaged in the market not to need further protection. Should the exercise be repeated for those customers who chose to remain with the initial large supplier? Should it be repeated for other vulnerable customers? There would be advantage in waiting to see how the market and public opinion develop. For example, has the process made a significant difference to the prices paid by such customers, or not? Have there been many or few transfers of whole tranches of customers to other suppliers? Presumably there is now more evidence bearing on the costs to serve of particular kinds of customers – does this suggest that "unfair price differentials" are more or less widespread than previously feared? It will also be relevant to take account of the costs of the process, both to the suppliers involved and in the form of providing advice to customers.

11. Conclusion

Ofgem has called for "a replacement for the price cap" in order to protect vulnerable customers. I and others have argued that the competitive market is already effective and protects even vulnerable customers, but the present paper seeks to address Ofgem's challenge without assuming this. The suggestion in this paper is to use competition as a rivalrous discovery process, first to check whether and how far there are excess (or unfair) prices for particular vulnerable customers, and second to address such a concern, if well-

founded, by enabling a transfer of customers to suppliers willing to offer lower prices at acceptable qualities of service.

The approach can be tailored to such customers as Ofgem deems vulnerable and in need of protection. It provides for customer choice, supplemented by advice and support as needed. It provides the opportunity for exploring different approaches and for learning from experience. It can also be continued, expanded, contracted or terminated as the need arises.

The proposed approach develops the process of customer engagement, via collective opt-in switch trials, that Ofgem has been actively exploring at the suggestion of the CMA. The advantages of the proposed approach over the previous process are several. First, it is more focused on specified vulnerable customers, not on all 10 million or so customers that have been with their present supplier for three or more years. Second, it aims to establish whether there is a significant and continuing problem, rather than simply assuming that there is such a problem. Third, where there may be excessive prices, it aims to find suppliers that are best fitted to serve these particular customers, in terms of quality of service as well as price. Fourth, in doing so, the process sheds light on the price at which other suppliers are prepared to serve these kinds of customers, which is presently a matter of dispute. Fifth, it seeks to reinforce the competitive market process in terms of facilitating the voluntary transfer of customers between suppliers, rather than to undermine it by expropriating customers that have been loyal to particular suppliers.

In addition, the approach offers an answer to Ofgem's request for "a replacement for the price cap", when no alternative proposals seem to be apparent. It could enable an earlier removal of the PPM and default tariff caps. There are, nonetheless, potential legal and other practical problems associated with the proposed approach. This paper is an attempt to explore such issues and to find a way through to life after the price caps, and sooner rather than later.