Price discrimination, efficiency, fairness and loyalty premia in the retail energy sector: Brief thoughts in response to the NIC Regulation Study.

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The terms of reference for the National Infrastructure Commission (NIC) Regulation Study, and its call for evidence, suggest that topics covered may include the efficiency and fairness of price discrimination, particularly so-called "loyalty payments". The CMA has recently recommended "eight key reforms to address the problems related to the loyalty penalty". (CMA, *Tackling the Loyalty Penalty: Response to a super-complaint made by Citizens Advice,* 19 December 2018, para 25) The present comment responds to this issue with particular reference to the retail energy sector. (Although energy was not one of the five sectors referred to the CMA by Citizens Advice, examples were nonetheless given from that sector, and the scope of the NIC's study and therefore its potential recommendations include the energy sector.)

In the domestic retail energy market, and no doubt in other markets too, there have been suggestions that there is a "two-tier market", that the lower tier price is the competitive or fair price, and that loyal customers paying the higher price are being exploited and are paying a "loyalty penalty". There are also suggestions that this price differential should be limited or removed, if necessary via the introduction of (absolute or relative) price caps.

Such a characterisation is unduly simplistic.[2] In reality, the UK retail energy market exhibits a great variety of prices and product variants and cost differences. Further price caps and other restrictions would likely make things worse. More moderate measures are a more sensible way forward.

1. The dangers of unduly simplistic analysis and interventionist policy

Consider the retail energy market. Until 2008, Ofgem had pointed out that lower prices could be secured by switching supplier and instanced this as evidence that competition was working. In 2008 Ofgem suddenly pointed out that higher prices would be paid by not switching supplier, and instanced this as evidence that competition was not working. There was no change in the extent of competition, but rather a simple change of assumption as to what was the "competitive price".

The real problem at the time was that retail energy prices were rapidly increasing, largely as a result of increases in world fuel prices outside the control of the retail suppliers. Ofgem could do nothing about those increases, but decided to take action by introducing a non-discrimination condition. It suggested that customers paying the higher prices would henceforth benefit by paying the lower prices. In the event, suppliers withdrew the lower prices, and all customers paid the higher prices.

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[2] A point that the Chief Executive of Ofcom has recently made: "as we've analysed handsets and broadband pricing, it's clear that phrase ['loyalty penalty'] doesn't capture the complexities of the market". Fairness must come first, Speech by Sharon White at Ofcom/Which? fairness event, 3 June 2019

Regulatory intervention did not benefit the less active customers and made other customers worse off.

Ofgem responded by replacing the non-discrimination by various "simple tariff" restrictions. These too seemed not to benefit customers. The CMA *Energy Market Investigation* (Final report, 24 June 2016) found that Ofgem's interventions had had an Adverse Effect on Competition (and on customers), and recommended they be withdrawn.

2. Price and product differentials can reflect competition

Price discrimination is often represented as a way by which a firm with market power exploits those of its customers that have no or few alternative sources of supply. But it is equally a means by which a firm without market power can compete to supply additional customers, by offering a lower price that would not be viable if it had to offer it to all its customers. (In economic terms, it can offer to some customers a price that covers the incremental or marginal cost of supplying those particular customers, which would not cover the average cost of supplying all its customers.)

Similarly, product differentiation is sometimes represented as a way by which firms confuse customers or "obfuscate" the market, in order to charge higher prices. But it is not credible that an individual firm would offer an unnecessarily complicated product in order to confuse customers as a whole. Rather, in differentiating their products, firms are looking for ways of making them more appealing so that they can attract new customers. Sometimes they might do this by providing added value, which might enable them to charge a higher price; at other times they might be able to reduce so as to enable them to charge a lower price. Again, product differentiation is a way of competing.

3. Observed price differentials may reflect differentials in products or in costs to serve

Perceptions of the present UK retail energy market have been coloured by the CMA *Energy Market Investigation Final Report* 2016. This claimed that "weak customer response" gave market power to suppliers, which they used to increase prices and engage in price discrimination, generating an estimated customer detriment of £2bn in 2015. This finding was widely cited in political manifestos and used to justify the subsequent imposition of a widespread tariff cap, as well as other allegedly remedial measures. However, the nature and significance of these calculations have been strongly challenged, not only by the larger suppliers but also by myself and other former UK energy regulators.[3]

There is no doubt that there are significant price differentials in the energy market. Differentials of £200 or more have been recently observed (in an average annual bill of around £1000). Some have claimed this to be evidence of a loyalty premium associated with lack of competition. But closer examination suggests that these price differentials reflect many different factors.

[3] E.g. Submission by former UK energy regulators to House of Lords Economic Affairs Committee, at https://www.eprg.group.cam.ac.uk/wp-content/uploads/2017/01/S.-Littlechild_Submission-to-H-of-L-official-version-46083.pdf Also Stephen Littlechild, "Competition, regulation and price controls in the GB retail energy market", *Utilities Policy*, Volume 52, June 2018, Pages 59-69.

Importantly, there are differences in products e.g. fixed versus variable tariffs, or tariffs fixed over different time periods, hedged or unhedged products, different payment methods including payment upfront or in arrears, the extent of green energy and how that is provided, possible initial discounts, availability of personal contact or just internet chatrooms, with paper bills or paperless, with or without other products such as boiler servicing, etc.

Suppliers themselves vary greatly. Some have good customer service ratings, others do not. Some are well-established and well-funded, others are not. Some are required to provide a range of social and environmental obligations, others are not. Some are loss-making as a deliberate strategy to gain market share, others are not. Some are financed by local authorities, others are not. Some suppliers have continued to provide service over the two decades for which this market has been open. But over a dozen suppliers have had to leave the market in the last year or so, and recent press speculation suggests that another "nine energy firms face collapse". (*Sunday Times*, 22 September 2019)

It follows that some tariffs are more risky than others. Although Ofgem takes steps to protect customers of failing suppliers, there is generally a period of uncertainty and worry for such customers. Hence it is prudent to consider risk as well as tariff level.

Price differentials also reflect cost differentials, and differences in cost to serve different customers can be significant. Most suppliers offer lower prices to customers that pay by direct debit and are willing to transact online, because such customers are typically lower cost to serve. Not surprisingly, many newer suppliers focus on attracting such customers. As a consequence, more established suppliers have a higher proportion of customers using other payment methods, either by prepayment meter (PPM), or payment in arrears by cash or cheque. Some of these customers are in financial difficulties, some are vulnerable. They typically require personal contact rather than online communications. On average, they are higher cost to serve than direct debit customers. Not surprisingly, the tariffs to such higher-cost-to –serve customers are higher than for the lower-cost-to serve customers. That is to be expected in a competitive market. It is not a sign that the market is not competitive. And other measures may be appropriate to address any fairness concerns here, as indicated below.

4. Are differences in bills the same as differences in tariffs?

As noted, concerns have focused on significant differences in prices or tariffs. It is suggested – or assumed - that those customers that are able and willing actively to engage in the market can secure very much lower tariffs than those who, for one reason or another, are unable or unwilling actively to engage in the market. The size of such tariff differences has led to protests about the "loyalty premium" and thence to calls for substantial policy intervention.

But are these tariff differences an accurate reflection of the differences in bills that customers actually pay? Recent research by the Victoria University Energy Research Centre, Australia, casts some doubt on the extent of the differences in bills. "This research examines 50,000 Victorian household electricity bills. It finds, contrary to common wisdom, that switching electricity retailer does not greatly reduce the amount of money that most households leave on the table." (at https://www.vepc.org.au/) Customers that have not switched recently could save on average A$281 per year by switching to the lowest tariff. But those who have switched recently could also make significant savings – on average, the actual achieved difference in bills is under A$50 a year. In reality, then, there is no great loyalty premium.

This highlights the need for further research before concluding that there is a significant "loyalty penalty" that requires significant regulatory intervention. (I understand that Ofcom is carrying out some research along similar lines, and it would be helpful if Ofgem were able to explore this issue too.)

5. Policy going forward

The CMA *Tackling the Loyalty Penalty Report* suggested a package of eight key reforms to address the problems it identified. Although it mentioned targeted intervention such as limiting price differentials or price caps, it did not claim that the case for these was established. Nor is it. In addition, there are substantial risks in implementing such a remedy, as the CMA's own recent experience of setting a tariff cap on prepayment meter tariffs has demonstrated. Ofgem has now admitted that during the initial periods that cap was unintentionally set below cost, and the cap has subsequently had to be adjusted upwards. Meanwhile, competition for PPM customers was severely restricted and the customers themselves suffered because at the regulated tariffs they were not attractive to suppliers.

The CMA recommended various other measures, notably, working towards a "better understanding of the loyalty penalty across markets". This seems sensible. Perhaps it could usefully be combined with further analysis of what constitutes undue (as opposed to due) discrimination. (There are methods of doing this. During the 1990s, Ofgas compared the tariffs offered by British Gas against the avoidable costs of customers on these tariffs to assess whether the discrimination was "undue".) Meanwhile, those suppliers who do not impose "loyalty penalties" can make their case to customers as part of their commercial marketing strategy.

Those customers increasingly left on the higher tariffs might, on average, be more vulnerable and higher-cost-to-serve customers. If so, the appropriate policy is not to ignore this and require that suppliers charge all customers the same price. Rather, as the CMA *Tackling the Loyalty Penalty Report* suggested, there are ways of "giving people more help in getting better deals". It recommends that Government "Empower intermediaries to support switching, for example considering giving a greater role to local consumer-facing advisory organisations, such as Citizens Advice, who could do more to support switching for vulnerable consumers." (p 138) And if it is desired that certain kinds of vulnerable customers pay the same price as other customers, or a price below the cost of serving them, then it is appropriate to explore alternative ways of achieving this – for example, by utilising or reforming the Warm Homes Discount policy.

In light of the above, the NIC can make a valuable contribution to this debate by urging further research into a complex and sensitive phenomenon, and by cautioning against a premature rush to further price controls.