

# **Time to stop digging: A submission to Ofgem's Review of its Forward Work Plan**

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## **1. Summary**

Ofgem has invited comments on its Forward Work Plan for 2021/22. The Work Plan seems well-considered and comprehensive, and this submission is concerned with only two apparently small aspects of it. However, these two aspects could nonetheless be problematic, and jeopardise the achievement of the objectives of the Work Plan as a whole, if not addressed constructively.

The Work Plan proposes to develop options such as collective switching to protect customers beyond the end of the current default price cap's expiry. Collective switching and a default tariff cap help some customers but they have downsides. The tariff cap reduces the ability and incentive of suppliers to enter, innovate and invest in the industry. Collective switching has a similar impact insofar as it encourages customers to leave their suppliers. Moreover, given the extent of previous concerns about the sector, it seems unlikely that collective switching will so transform the market, and popular and political beliefs about it, that the tariff cap will easily be allowed to expire.

Collective switching and a continued tariff cap thus seem inconsistent with the kind of future market that Ofgem envisages. Instead, a market in which suppliers work constructively with customers, and where customers trust rather than distrust their suppliers, seems more conducive to achieving the aims of the Forward Work Plan, not least making the desired transition to a net zero energy system.

This submission suggests that, as part of its Forward Work Plan, Ofgem should include four additional activities:

- i) First, stop digging: move on from the incorrect narrative of an uncompetitive and inefficient retail market with significant customer detriment, and develop and communicate more broadly a better understanding of how this competitive market actually works, and why certain regulatory interventions could be beneficial but others could be counter-productive;
- ii) Second, shift the focus from trying to persuade more customers to leave their present supplier to explaining that customer loyalty is in general a good thing where it is deserved, acknowledge that although price is important it is not the only consideration, and assist customers to make informed choices of tariff and product, but also considering supplier reputation, so that customers do *not* need repeatedly to switch supplier;

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- iii) Third, if collective switching is to be considered, use it as a means of discovering the competitive price for serving particular kinds of vulnerable customers, with the emphasis on products to meet their needs, and working with existing suppliers rather than against them;
- iv) Fourth, develop a strategy to remove or relax the present tariff caps, and at least ensure that a convincing case can be made for not renewing them at the end of 2023.

## **2. Outline of this submission**

- Section 3 suggests that, as regards the retail market, the CMA Energy Market Report 2016 dug a large hole, and the question now is whether to keep digging or to take steps to get out of it.
- Section 4 explains why the narrative of an uncompetitive retail energy market was and is incorrect.
- Section 5 explains why the CMA's calculation of a significant customer detriment was inappropriate and an order of magnitude too high.
- Section 6 notes that some of Ofgem's previous policies, and the CMA's analysis, reflect the assumption that energy is a homogenous product hence the failure of many customers to respond to significant price differentials constitutes "weak customer response" rather than rational economic decision-making, and argues that this behavioural perspective has been problematic and taken too far.
- Section 7 cites a recent study by University of East Anglia economists finding that customers' decisions in "The Big Switch", including not to switch, were largely rational economic decisions and customers did not regard energy as a homogenous product, so that automatically moving customers to a cheaper supplier may reduce utility for some customers.
- Section 8 provides further evidence of product differentiation, showing that apparently high tariff savings are not in fact available to (and hence not ignored by) customers that have plausible preferences for particular tariff features.
- Section 9 notes a recent finding by Cornwall Insight that, of the suppliers offering the ten cheapest tariffs over the period 2015-17, four out of ten suppliers subsequently exited the market; and summarises some recent evidence from Uswitch that "brand matters" in customer choice, so encouraging switching to a lower cost supplier is not necessarily better for customers.
- Section 10 finds a continued spread of tariffs in the market, mainly reflecting a predominantly falling wholesale cost during the tariff cap period, and varying with the extent to which wholesale costs rise or fall, and suggests that smaller suppliers have no alternative but to maintain a tariff spread if they are to stay in the market.
- Section 11 finds that the tariff cap has led, if anything, to a greater proportion of suppliers differentiating their fixed and variable tariffs, suggesting that such differentiation is not exploitative but a normal feature of a very competitive market.
- Section 12 shows that the tariff cap has led to serious financial losses and to a market that prudent investors are exiting rather than entering.

- Section 13 notes the support for a tariff cap by the New Large suppliers, who have an impressive record in terms of efficiency and innovation, but notes also that these suppliers stand to gain from a tariff cap, relative to their competitors.
- Section 14 conjectures (tongue only slightly in cheek) that, if Ofgem decided again to refer the retail energy market to the CMA, to decide on a future tariff cap, the CMA using the same approach as before might well recommend an even tougher cap plus a cap on the charges that New Large suppliers make for new retail platforms, which might in turn lead to calls for renationalisation.
- Section 15 reviews the pros and cons of opt-in and opt-out switching and indicates some of the problems that arise in such switching policies once it is appreciated that customers have preferences as regards products and suppliers.
- Section 16 suggests that the time has come to stop digging a bigger hole, to acknowledge the limitations of some previous interpretations and to explain various competitive aspects of the retail market.
- Section 17 notes that supplier reputation is important for customers, suggests that it would be useful to facilitate the development of supplier reputations in the retail market, and notes a proposed approach to calculating an Overall Customer Satisfaction score as a means of doing this.
- Section 18 suggests that collective switching could be used to discover competitive prices for vulnerable customers.
- Section 19 argues for developing a strategy to remove or relax the tariff caps, and at least to ensure that a convincing case can be made for removing them at the end of 2023, and suggests that subsequent resettings of the cap should gradually relax it until, if not removed by the end of 2023, it cannot plausibly be argued that not renewing it then will lead to significant tariff increases.
- Section 20 concludes by reiterating that artificially holding down prices and profits, and targeting suppliers' customers with an intent to persuade them to leave their suppliers, will not encourage investment by suppliers, or build the "partnership between the regulator, governments, energy companies, and energy consumers" that Ofgem sees as necessary to achieve "the transition to net zero", hence it is important that the Forward Work Plan include steps to remove or replace the tariff cap.

### **3. Digging a hole**

The CMA Energy Market Report 2016 was very informative and constructive in many respects, but as regards the retail market it dug a large and deep hole. It found inexplicable price differentials in the domestic retail market, which it saw as confirming Ofgem's belief that there was "weak customer response" in this market. It calculated that this represented a customer detriment of £1-2bn per year.

Political parties, media, Government and Ofgem variously jumped, fell or were pushed into this hole. And started digging. There was overwhelming political pressure for a tariff cap, eventually imposed as of January 2019, to narrow the price differentials and protect these irrationally disengaged customers. And also to punish the large suppliers for their supposed

excess profits and inefficient costs. Ofgem carried out numerous trials of measures to persuade customers to change supplier. But price differentials remained, customers were still not active enough. In October 2020 Ofgem advised that competition was not effective, and the Secretary of State extended the tariff cap to the end of 2021.

Now, more digging is envisaged. Indeed, the Energy White Paper proposes to test and potentially implement opt-in and opt-out switching, seemingly by changing the law and without reference to Ofgem. Even if these processes could be made consistent with data protection concerns, and could be extended to include quality of service and risk as well as price, will they really suffice to reform recalcitrant customers, “strengthen” customer response and reduce price differentials, to the extent that retail competition can be declared effective? Or will such customers have to be migrated to customer retraining camps released only when they promise to be disloyal to all future suppliers? Meanwhile, will the tariff cap simply be renewed, and renewed again, because there is no economically plausible or politically acceptable basis for removing it?

This paper proposes an alternative view. Although the CMA report was valuable on many issues, its analysis of the retail market was mistaken. There was no customer detriment of the order of £1-2bn per year. Although some features seemed problematic, this was and still is probably the most competitive domestic retail energy market in the world, and just as competitive as markets for other consumer products.

The tariff cap seems to have reduced the prices of the tariffs that it covers, to the short-term benefit of these customers, but there are still significant tariff differentials, so it has not “cured” that perceived “problem”. Importantly, the tariff cap has already had harmful and distorting effects on competition, including driving out competent and well-financed suppliers. This is not conducive to future investment and innovation and customer participation in this sector – which BEIS and Ofgem see as crucial in order to achieve the Net Zero Future.

The following material expands upon some of these points, and suggests an alternative emphasis for Ofgem’s future work in this area, that could better achieve the underlying aims of the Forward Work Plan.

#### **4. The incorrect narrative of an uncompetitive retail market**

In introducing its Strategic Narrative (11 July 2019), Ofgem claimed that: “the legacy of many years of a concentrated, uncompetitive retail market is widespread cost inefficiency”. This is seriously incomplete and misleading. Certainly there were significant cost differences as of 2015, when the CMA looked at the situation, but this did not constitute “widespread cost inefficiency” and it was not “the legacy of many years of a concentrated uncompetitive retail market”. There are cost differentials in all competitive markets, and they need to be seen as part of the competition as a rivalrous discovery process taking place over time. And regulatory restrictions played a significant part too. A correct diagnosis of the “problem” is necessary if a correct “solution” is to be found, and if harmful incorrect “solutions” are to be avoided.

To explain briefly the actual history, after the Government's golden shares in the Regional Electricity Companies lapsed in 1995 there were many mergers and takeovers reshaping the retail market, including takeovers by experienced overseas companies. The generally held view was that suppliers needed to be larger than hitherto in order to compete effectively, both to reap economies of scale in retail and to sustain their own generation fleets since the wholesale market was not yet fully competitive. The evidence supports this judgement: a number of small and independent new suppliers entered but only half a dozen survived, with aggregate market share not exceeding about 1%.

Nonetheless this was not a particularly concentrated market – for example, it was about the third or fourth least-concentrated retail energy market in Europe. And this was a very competitive era, as Ofgem itself pointed out, with all players making significant incursions into the territories of historic incumbent retailers, changes in market shares, many takeovers, innovations in tariff structure and payment methods, and a steady increase in the switching rate from around 15% a year in 2004 to 20% per year by 2008, as high as anywhere in the world at that time.

As explained shortly, retail prices declined steadily until 2008 then began to rise sharply, in both cases reflecting movements in wholesale prices. There was a change in Ofgem personnel and policy. In 2009 Ofgem introduced a non-discrimination condition, severely restricted doorstep selling, and later limited suppliers to “simple tariffs”. Although the market did not become “uncompetitive”, competition was nonetheless restricted, changes in market shares were reduced, by 2013 the switching rate had halved to 10%, and the aggregate average pre-tax (EBIT) profit rate of the large legacy suppliers increased from under 1% in 2009 (artificially low as a result of lagged response to wholesale cost increases – which does not suggest market power until then) to over 4% in 2012.

Economists documented various adverse effects of this regulatory policy, and one of the reasons for the 2014 CMA reference was to assess it. The CMA confirmed the criticisms, and formally found that Ofgem's regulatory restrictions had had an Adverse Effect on Competition and should be removed. This was done. Unfortunately, the CMA also confirmed Ofgem's belief in weak customer response, and this continues to impact the policy debate today.

There is no reason why the extent of competition, or Ofgem's then restrictions on competition, should have reduced the incentives of the large suppliers to be efficient. On the contrary, in the early 2010s these large suppliers were actively seeking to increase their efficiency and effectiveness by unifying and modernising the paper-based legacy IT and billing systems of their various component companies. Four of them adopted the German SAP system (Scottish Power, nPower, EDF and British Gas, in roughly that order) and one supplier (E.On) did so in part. SAP was at that time considered to be the best system available. In the event, however, the customisation and integration of these SAP systems proved significantly more problematic, time-consuming and expensive than expected, and in some cases led to temporary failures in customer service as well as higher costs.

The large suppliers had an additional incentive to increase efficiency because, also during the early 2010s, for the first time, new entry on a smaller scale became economic. Improved and lower cost IT and billing and collection systems were being developed, geared to quick and small scale entry. These various off-the-shelf and ‘supplier in a box’ models provided potential entrants with companies that had been taken through Ofgem and other entry processes and could be rented rather than purchased outright. Increasingly they also offered outsourced customer management services and related support infrastructure. At the same time, competition in the wholesale market was increasing, and large wholesale energy providers were willing to provide low-collateral trading and management of small suppliers’ trading positions. The growth of Price Comparison Websites served to inform, assist and encourage potential switchers, and by the same token new entrants could appear in these comparisons and benefit from their massive marketing. Government and Ofgem took steps to facilitate new entry, including by exempting new entrants from significant social and environmental costs. The number of entrants increased fourfold, from 6 at end 2010 to 23 in early 2015.

So, when the CMA took its snapshot of the industry in 2015, it found most of the large suppliers hit by the unexpectedly high costs of the SAP systems but still accounting for 90% of the market, and two dozen small and medium suppliers with new and low cost systems but accounting for only 10% of the market. Unfortunately the CMA interpreted this as a static, concentrated, inefficient and uncompetitive market instead of realising that it was a very competitive market at the beginning of a second phase of radical transformation. The growth of the small and medium suppliers at the expense of the original large suppliers had only just begun and had not yet had time to play out.

But increasingly this aspect of the competitive process has indeed played out. Thus, a former medium supplier (Ovo) has taken over one of the former large incumbent suppliers (SSE). The market share of the other five former large suppliers is down from about 75% in 2015 to about 55 % in mid-2020, and one of them (npower) has been taken over by another (E.On). The remaining small and former medium suppliers increased their numbers from 23 in 2015 to a peak of 64 suppliers in 2018, and tripled their market share from about 10% to about 30%.<sup>2</sup> Two suppliers (Bulb and Octopus Energy) that had barely entered the market in 2015 are now classed as large suppliers with over 1 million customers (and each has ambitions to have 100 million customers worldwide within another ten years).

Thus, despite cost differences at any point in time, the GB retail energy market always has been, and continues to be, an extremely competitive retail market.

## **5. The CMA’s calculation of customer detriment**

The CMA compared the average price charged by the large suppliers against the price that it assumed would be charged by “a hypothetical construct, a ‘supplier’ that is a combination of

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<sup>2</sup> Source: Ofgem data portal market shares for electricity, Q1 2015 to Q3 2020; comparable figures for gas are 76.5% to 57.5% and 8.5% to 30%.

the suppliers that we have identified as being the most competitive in the markets”. On this basis it estimated a customer detriment averaging £1.4bn a year, reaching almost £2bn in 2015.

This “hypothetical construct” seems essentially to be what the CMA *Guidelines* call “an idealized perfectly competitive market”. Hence to use it seems inconsistent with the CMA *Guidelines*, which say that such a benchmark will *not* be used.

A closer examination reveals that such a market was quite unrealistic at that time: the larger companies could not have achieved the lower costs of the medium-sized ones, nor could the small and medium new entrant companies have expanded to meet the market demand at their then cost levels.<sup>3</sup> If the CMA had used a more realistic approach, understood the history, and acknowledged companies’ actual costs and capacities - for example as it did in assessing the cement market – it would not have found any customer detriment.

Normal competition authority practice, including at the CMA, was and is to give considerable weight to excess profits (not including alleged inefficiency). Using as a benchmark the profit rate in the very competitive market for large industrial customers, excess profits in the domestic market averaged about £170m per year over 2007-2014. This was around £6 per household per year, an order of magnitude lower than the £75 per household cited in the CMA report. It certainly did not justify price control and merited, at most, a suggestion that Ofgem might explore whether customers should spend more time and effort switching energy suppliers.

## **6. Weak customer response**

The CMA took the view that energy was a homogenous product - it was the same whoever supplied it – so the CMA could not understand why there were significant difference in the prices charged by different suppliers, and indeed in the levels of different tariffs offered by the large suppliers. Why didn’t customers move to a lower cost supplier, or to lower price tariffs? This was particularly puzzling because, for lower income customers, the level of the annual energy bill was presumably very significant.

The CMA’s explanation was “weak customer response”: essentially (in my words) many customers didn’t know what they were doing, or were doing the wrong thing, or not doing anything. The CMA therefore recommended that Ofgem take steps to promote more active customer engagement (again in my words, to explain to customers what they should be doing and persuade them to do so).

Weak customer response was not the CMA’s invention, it was one of the concerns that the CMA and Ofgem jointly identified before the reference, and a concern that Ofgem asked the CMA to particularly investigate. It was something that Ofgem stumbled on in explaining its

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<sup>3</sup> S C Littlechild, “The CMA’s assessment of customer detriment in the UK retail energy market”, *Journal of Regulatory Economics*, 57(3): 203-30, available online 28 June 2020.

2008 change in regulatory policy that the CMA later found to have had an adverse effect on competition.

Briefly, changes in retail prices reflected changes in wholesale market prices. In real terms, domestic energy prices declined fairly steadily from 1985 to 2005, by about two thirds in total. But then wholesale prices suddenly began to increase sharply, as did retail prices, which no less than doubled from 2005 to 2010. Not surprisingly there was considerable public and political concern. In 2008 Ofgem launched an investigation (the *Probe*), and acknowledged the external cause of price increases which neither it nor the retail suppliers could do anything about. However, without detailed cost information Ofgem was unwilling to defend the competitive market and the price increases.

But Ofgem (encouraged by Government) felt that it had to Do Something. A culprit had to be found that could be blamed and dealt with. As former GEMA member Professor George Yarrow has explained, Ofgem deflected attention from absolute prices to relative prices – particularly the difference between prices that suppliers charged within and outside of area – which Ofgem *could* do something about.<sup>4</sup> With the support of Energy Secretary Ed Miliband, Ofgem introduced the non-discrimination condition. It also drew attention to inactive customers, arguing that this meant that the constraint on suppliers imposed by the ability of customers to switch was a weak one. So Ofgem also proposed measures to increase customer engagement.

However, the non-discrimination condition increased the lowest prices and reduced the savings from switching. Together with Ofgem’s crackdown on doorstep selling, it led to a noticeable reduction in the switching rate which, as noted, halved from 2008 to 2013. Ofgem’s Retail Market Review did not acknowledge the adverse effects of its own non-discrimination and doorstep selling policies, but instead continued to blame companies and customers. In March 2011 Ofgem proposed the numerous components of its next remedy, the ‘simple tariffs’ policy, intended to increase customer engagement. In parallel, Ofgem announced that it had “implicitly used insights from behavioural economics for many years” to deal with “weak customer engagement”. Ever since then, weak customer engagement/response has featured centrally in Ofgem, CMA and Government analyses of the retail market.

Ofgem cited the OFT’s paper “What does Behavioural Economics mean for competition policy? (March 2010). That paper referred to the “virtuous circle between consumers and competition” in which “well informed, confident, rational and effective consumers can play a key role in activating vigorous competition between firms”, who in turn deliver what customers want. But behavioural biases “can impact on the extent to which consumers play their active, effective, and rational part in this virtuous circle”.

But how far can and should regulators try to remove such perceived biases? Unfortunately, in its quest to stimulate customer engagement to achieve what it referred to as its “vision” of a

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<sup>4</sup> G Yarrow, Energy Market Investigation, response to the CMA’s statement of issues, 14 August 2014, and Transcript of hearing at CMA Energy Market Investigation, 11 December, 2014.

competitive market, Ofgem seemed to overlook the cautionary advice in the OFT paper. This included, “In most circumstances, the pricing, marketing, and advertising practices of firms can still be viewed as benign with no need for action”; “markets can be self-correcting and interventions can potentially do more harm than good”; “In many instances, the problems arising from behavioural biases will be solved by the actions of market participants themselves”; “it is not always clear that interventions will improve outcomes for consumers. This is nothing new, having been recognized by John Stuart Mill over 150 years ago: ‘All errors which [man] is likely to commit against advice and warning, are far outweighed by the evil of allowing others to constrain him to what they deem his good.’”; “it may be that authorities simply do not have the level of expertise required to make delicate interventions. In such situations an authority would be wise to be conscious of its own limitations”; “this [focus on consumer and firm behavioural biases] does not preclude the possibility of authorities having behavioural biases as well”.

There is a balance to be struck, but is a continued emphasis on weak customer response in the retail energy sector still justified? People are generally trusted to make broadly sensible decisions on whether and who to marry, how to bring up children, what schools to choose, what jobs to take, what houses to buy or rent, what clothes and food and holidays to buy ... and yet, doggone, most people just can’t get the hang of buying gas and electricity. They persist in sticking with the suppliers they have been content with, even though other suppliers appear to offer lower prices. So there is just no alternative but to keep trying to put these customers right. And until customers start to behave properly, retail suppliers are just going to have to be subject to price controls.

Is it not conceivable that people know what they are doing, to about the same extent in energy as in other activities? Of course, everyone would like lower prices of everything, other things being equal. But those customers who do not change energy supplier take the view that other rival suppliers have not yet convinced them of the case for switching. They give priority to other decisions, like the important ones just listed, or to other activities in a usually busy life. Are they wrong? Might they not have a point?

## **7. Are customers rational?**

The behavioural economics view is that customers are subject to behavioural biases that may prevent them from making rational economic decisions, so that regulators have to intervene to try to put them right. Against this, economists have generally argued that customers do in fact act consistently with conventional economic principles. For example, some customers may prefer not to choose, and searching, evaluating and switching to alternative suppliers is costly. So customers that do not switch to a lower cost supplier may not be acting irrationally at all.

A recent and careful study of The Big Switch [TBS] run by Which? lends support to this latter interpretation.

While we find that switching is positively correlated with the savings offered to participants, the raw data clearly demonstrate that the prospect of substantial savings is not by itself sufficient to induce a

majority of participants to switch, despite the small additional effort required and several reminders from Which?. A range of non-price factors – various sources of uncertainty, the non-monetary characteristics of different offers, concerns about the switching process and time pressures when TBS occurred – are all associated with the switching decision. Some other features, such as the seemingly disproportionate weight attached to exit fees and the negative impact of seeing two offers rather than one, may have elements of behavioural bias, but most of the factors we identify are consistent with consumers making a largely ‘rational’ decision when declining to switch, even if this results in substantial monetary savings apparently being left on the table.<sup>5</sup>

The authors note that these findings have important policy implications. For example

These non-price preferences confirm that consumers do not regard energy as a homogeneous product, despite the view of many analysts. So our second policy conclusion is that actions which automatically move consumers to a cheaper supplier may reduce utility for at least some consumers, since they do not regard suppliers as completely interchangeable.

The next two sections offer some further complementary evidence showing that product differentiation and branding may explain apparent irrationality and weak customer response.

## **8. Competition as a faster horse?**

Henry Ford is sometimes (wrongly) supposed to have said “If I had asked my customers what they wanted they would have said a faster horse.” The faster horse view of competition sees retail energy products as homogenous, with competition working insofar as it produces faster horses, but not working insofar as some customers are refusing to choose the faster horses on offer.

But competition also produces other means of travel, some of which are faster than horses but perhaps perceived as riskier, and others might be slower than horses but safer or more comfortable.

Consider the many retail energy offers apparently available on energyhelpline (a PCW used by Ofgem) on 4-5 October 2019. How far do they meet the preferences of three hypothetical but plausible consumers? Assume each has average annual consumption on a standard variable tariff with an incumbent large supplier, priced at the tariff cap, but they use different methods of payment and have different preferences and constraints.

Mrs A is an elderly widow paying by direct debit, and apparently has over 150 tariffs from over 50 different suppliers that would offer a saving compared to her present bill. Two dozen of these tariffs would save her over £200, the highest saving being £328. But she is not keen to switch to a supplier not rated by Which?, or in the bottom one third of the Which? ranking. Nevertheless, this still leaves many savings around £200. Although she understands the market, she would rather play bridge with her friends than spend time repeatedly switching supplier or tariff, so she wants a variable tariff rather than a fixed price fixed period tariff. The available savings now fall to the range £2 to £168, median £47. Unfortunately she is not

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<sup>5</sup> D Deller et al, “Switching energy suppliers: it’s not all about the money”, *The Energy Journal*, 42(3), 2021, pp. 95-120, at p. 109.

internet savvy and is not comfortable with an online-only tariff. This leaves her with just two tariffs offering an annual saving of more than £5, viz. with Together Energy saving £37 and Engie saving £26. (Engie has since left the market and Together Energy is presently struggling with customer satisfaction rankings.)

Mr B does not have a bank account and pays on receipt of bill. Over 60 tariffs offer savings, 18 of which are over £100, 11 over £200 and the highest saving is £259. He doesn't understand the market, so he doesn't want to keep switching tariff because he thinks he will make a mistake, so his friend suggests he look for a variable tariff with a dependable supplier, let us assume the same Which? criteria are appropriate. His choice then falls to four tariffs offering an annual saving of more than £3, in the range £53 to £89. But one requires an Electric Vehicle, which he does not have, and another requires him to take telecoms services too. So he is left with two tariffs, viz. Utilita offering a saving of £89 (provided he has a smart meter installed) and Engie offering £57 but only £26 with paper tariffs, which he too would prefer.

Ms C pays by PPM, has a smart meter, is internet savvy, and doesn't mind whether fixed or variable tariff, online-only or paper bills. She seems to have only 10 tariffs offering a saving of more than £5 but the highest is £159. However, five of these suppliers do not offer the Warm Home Discount, which she needs to keep. A further three suppliers offer savings conditional on not having a smart meter and on having the new supplier install one, which is inapplicable to her. This leaves just two tariffs, viz. Green Star Energy saving £8 (which supplier has since left the market) and E saving £27 but with a further credit of £50 for keeping both electricity and gas accounts with E for at least another year. (E was a new supplier and had mixed customer ratings at the time, although it has since improved.)

Thus, at first sight it seems that these three customers, with three different payment methods, have, respectively, over 150, over 60 and 10 tariffs offering significant annual savings of up to £328, £259 and £159. If they don't switch supplier they seem to leave those large amounts of money on the table. But closer inspection reveals that, if these customers wish to continue to enjoy certain features of their present tariffs and products that they value, then the number of tariffs offering annual savings of more than £5 falls to just two for each customer, and their maximum savings reduce to, respectively, £37, £89 and £27 (plus a £50 voucher). Such savings are an order of magnitude lower than first appeared, and the customers might quite reasonably consider that they are not worth the effort.

All this does not indicate that competition is weak, but rather that it does not take the form of offering everyone a faster horse. Suppliers develop a variety of different products, some of which are significantly lower cost to supply than the traditional products. Many customers will benefit from this because they are able and willing to adapt, but many other customers may prefer to stick with the traditional products they are used to. In so doing, such customers are not exhibiting weak customer response, they are indicating that the savings available on the new product variants are, to them, not worth the unfamiliarity, inconvenience or risk that these different products would entail.

## 9. Uncertainty about suppliers and value of brand

Reference is often made to the difference between the tariffs of the large suppliers and those of their competitors. For example, Ofgem publishes a chart of various prices, including the cheapest tariff and the cheapest tariff basket (average of the cheapest ten tariffs), which are invariably lower than the average of the large supplier tariffs. But there is no indication of the nature or reputation of the suppliers involved.

Cornwall Insight (Domestic Tariff Report, January 2020) found that, over 2015 to 2017, on average, four out of the ten cheapest suppliers at any time subsequently exited the market.

My own examination of the tariffs listed by Cornwall Insight on 30 January 2021 showed that, of the cheapest 20 suppliers in the market, nearly half (9/20) were not well enough established to be rated by Which? and Citizens Advice, and none of the cheapest five suppliers were so rated. Moreover, of the 11 suppliers that were rated by these two organisations, over one third (4/11) were on average ranked in the lower half of an index of these ratings (the OCS score described below).

It is surely not surprising that customers do not immediately switch to a lower priced supplier if they know nothing about that supplier, and may not have heard of it before.

There is further evidence for this.<sup>6</sup> Uswitch is a major Price Comparison Website (PCW) that processes about 1.5 million switches per year, about 20% of the UK total. It confirms that price is an important determinant of switching – the switching rate is nearly double for a saving of £300 compared to £150. The proportion of customers that switch to a particular tariff is about twice as high if it is the lowest price tariff rather than the second lowest, and similarly for the third and fourth lowest price tariff.

In addition, “brand matters”: a recognised “brand” is very significant in customer choice. For a tariff in any position in the ranking (i.e. lowest price, second lowest etc), the switching rate to a large former incumbent supplier is greater than to a medium supplier, which in turn is greater than to a small supplier. The proportions seem to be roughly 5:4:2.

In other words, for large suppliers (and to a lesser extent medium suppliers) “brand” is an intangible asset because of the value that customers attach to their product. What is the nature of this value? The large suppliers are better known and more trusted, because they have been around the longest, have been known to the most people, and none of them has gone bust in the history of the industry. Not unreasonably, this seems to be significant for customers, especially when other lesser known suppliers come and go, often causing concern and disruption. Customers are prepared to pay more for a well-known brand, quite significantly more in some cases. The large suppliers, and to a lesser but increasing extent medium suppliers, thereby earn a return on the value of this intangible asset.

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<sup>6</sup> R Neudegg, “Drivers of switching beyond price”, presentation at Utility Week Energy Customer Conference, London, 22 January 2020.

## 10. Effects of the tariff cap on spread of prices

Some believe that the tariff cap has not been problematic, and indeed has had a positive impact on customers and the market. It seems likely those customers on standard variable tariffs have paid lower prices than would otherwise have been the case. According to claims by CMA/Government/Ofgem, something like £1.4 - £2bn per year, or £75 to £100 per customer, has been transferred to these customers.

Ofgem was concerned that a tariff cap would reduce the spread of prices and hence reduce the extent of customer switching, and thereby reduce the effectiveness of competition. Yet this does not seem to have happened. Savings of up to several hundred pounds against the tariff cap still seem to have been available, perhaps even higher than at some earlier times, and the switching rate continued at a high level until hit by covid.

Why did the spread of prices remain high? One factor is that, for the greater part of the period of the default tariff cap, wholesale prices have been falling. Ofgem's data portal shows that the wholesale element of the cap increased from £434 in winter 2018/19 to £505 in summer 2019 then fell to £432, £395 and £307 in the subsequent three periods. Since the cap is set some months in advance, this means that, during most of the period of the control, actual wholesale costs were lower than assumed in setting the cap, hence there was scope for suppliers to reflect this in those fixed tariffs that were not hedged against the tariff cap. By the same token, however, the spread of prices can be expected to narrow during a period of increasing wholesale prices. There is evidence of such wide and narrow spreads as a function of wholesale price changes, both before and during the tariff cap period.

To illustrate, take as a rough proxy of wholesale costs Ofgem's cheapest tariff basket, and as a measure of spread the difference between this basket and the average SVT of the large legacy suppliers (per Ofgem data portal). Compare the difference at dates where the cheapest basket (wholesale cost) has fallen to a low point and has risen to a high point. Thus at the three low points 28 May 2016, 28 April 2018 and 28 April 2020 the spreads were £323, £318 and £342 respectively. In contrast, at the three high points on 28 January 2017, 28 November 2018 and 28 December 2020 the spreads were £180, £127 and £157 respectively. So the spread of £342 in April 2020 was indeed high, but not far out of line with the spreads at the end of other periods of declining wholesale prices. As noted, the spread subsequently reduced to £157 in December 2020 (and may still be declining).

But why has the spread remained as large as it has, given that the tariff cap is said to have reduced the highest prices by £75 to £100? It seems to be, because smaller suppliers, who do not have "brand", have no alternative but to maintain significant tariff differentials if they wish to grow, or even to hold on to their existing customers, and simply to survive in the market. But the cost of this has been high, the financial losses have grown, and an increasing number of suppliers are being driven out of the market, as examined in the next-but-one section.

## 11. Effects of the tariff cap on supplier pricing policies

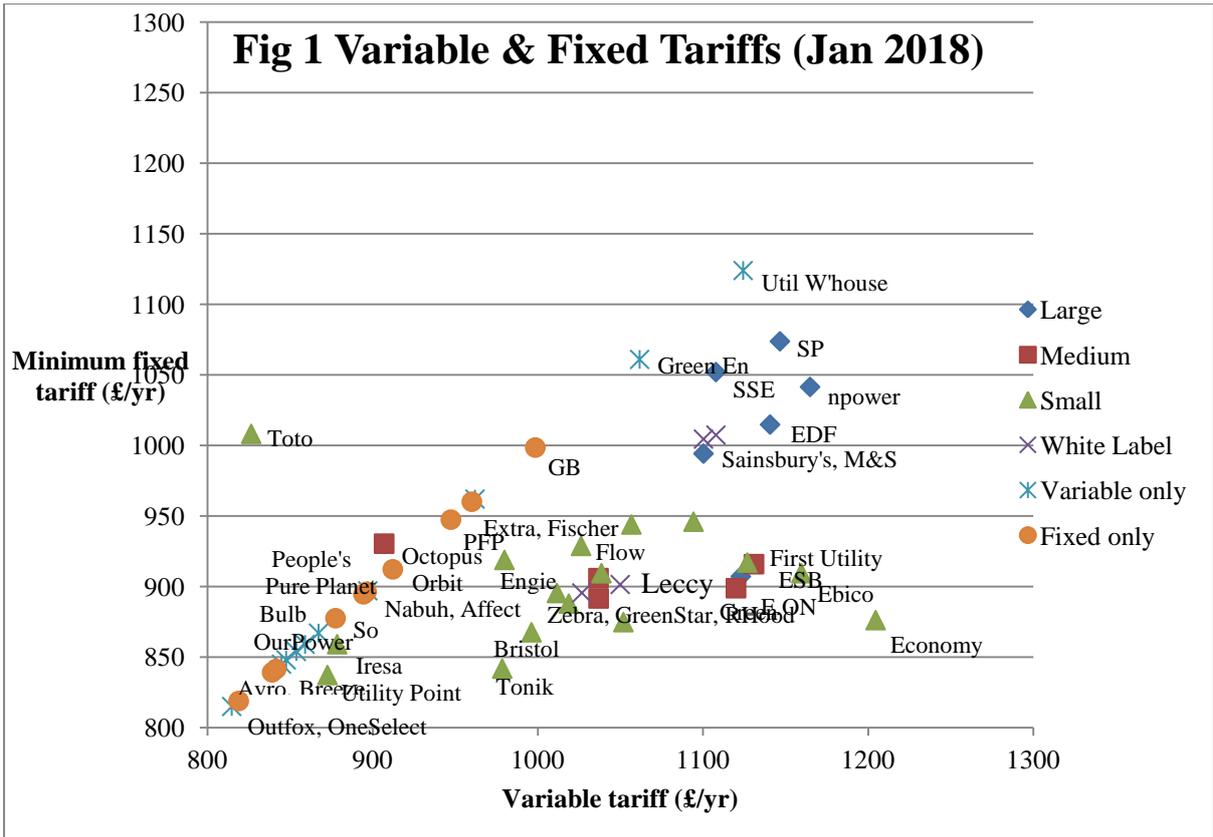
Until 2008, large suppliers competed by offering lower tariffs out of their local areas. In more recent years, they have offered fixed-price fixed-period tariffs at lower prices than their standard variable tariffs (SVTs). Some other suppliers have followed similar policies, generally at slightly lower prices, whereas yet others have offered only one tariff (which might be fixed or variable) or have offered fixed and variable tariffs closely aligned to each other.

A question of some interest is which kind of policy will prove most viable over the longer term. Will relatively uniform pricing, claimed to be “fair” to customers, prove to be attractive to most customers and also commercially viable? Or will most suppliers need to offer differential tariffs in order to survive? Or is a co-existence of policies possible and indeed economic, because there are differences among suppliers and among customers? This is competition as a rivalrous discovery process in action, and it is of some importance to know the answer because to impose a particular policy across the whole market could be less efficient and therefore adversely affect some or all customers. But also, if an attempt to impose a particular policy does not seem to be effective, it raises the question whether the costs to the suppliers of a different policy is so great that they need to maintain their original policies despite the cost.

Figures 1 and 2 give some indication of the pricing policies adopted by energy suppliers on particular days in, respectively, January 2018 and November 2020. The horizontal axis shows a supplier’s standard variable tariff, the vertical axis shows the supplier’s cheapest fixed tariff. (Note that prices of the lowest fixed tariffs, particularly, can vary quite significantly from one week to another, as participants dive into the market with an attractive offer, attract the number of customers for which they have hedged, and then withdraw that offer.)

Suppliers ranged along the 45 degree line are those with similar or identical fixed and variable tariffs, or only one of these tariffs. The further from the 45 degree line, the greater the differential between a supplier’s tariffs.

Figure 1 shows that, in January 2018, before the tariff cap, there was a considerable spread of suppliers around the bottom triangle of the graph. For example, a cluster of mainly large suppliers at the bottom right, with high differentials, a cluster of small suppliers at the bottom left with one low tariff or with relatively similar tariffs, and a significant number of suppliers in-between, with medium differentials and medium prices, and a significant sprinkling of yet other suppliers with medium differentials but higher prices.



How if at all has this changed nearly three years later, after the tariff cap? Figure 2 shows rather fewer suppliers (see next section) and smaller differentials (maximum around £200 rather than £300), but the same sort of overall pattern. Some suppliers have moved around – thus, as they have become more established, Bulb, Octopus and Affect have moved from the lowest uniform tariff group to a middle uniform tariff group, while Avro and So have moved from the lowest uniform tariff group to a middle tariff differential group. Ovo has moved from the middle tariff differential group to the high tariff differential group.

This admittedly limited observation of tariffs offered in the market over the last three years does not suggest that the tariff cap has reduced the proportion of suppliers offering significant tariff differentials – perhaps if anything the proportion of suppliers differentiating their tariffs is higher than before the tariff cap. This suggests that price differentiation is not just an exploitative pricing policy practised by those former incumbents that have long-standing loyal but disengaged customers, but a type of policy that is necessary for most suppliers to practice in order to survive in a competitive market like this one - as indeed Baumol showed.<sup>7</sup>

## **12. Effects of the tariff cap on profits and number of suppliers**

The tariff reductions of £1.4 - £2 billion have been at the expense of the shareholders in the suppliers, initially mainly the six large suppliers. From 2012 to 2017 the aggregate average pre-tax profit rate of the six large legacy suppliers (per Ofgem data portal) was more or less constant at just over 4%. In 2018 it fell below 3% and in 2019 to minus 1.48%.

But because other suppliers have to maintain prices below those of the large suppliers, they too are hit. Almost all other suppliers are making losses too. For 24 other suppliers the range of net profit margins posted for latest financial year 2019 or later is from minus 1% to minus 29.9%, with mean of minus 10.9% and median of minus 8.1%.<sup>8</sup>

In March 2020, the Chairman of the multi-utility Telecom Plus, whose subsidiary Utility Warehouse is a long-standing and successful energy supplier, commented as follows.

“With many independent suppliers continuing to set their retail prices at whatever level is required to attract new customers on price comparison sites, irrespective of the impact this is having on their profitability and cashflow, we have started to see record losses (in aggregate amounting to over £450m) being reported in their latest published accounts. Over 20 suppliers have left the market over the last two years, and in the absence of strong balance sheets to absorb their continuing losses, further insolvencies seem inevitable.”<sup>9</sup>

For all these companies, the ground has been cut from under them. They invested and entered the retail market in the expectation that it would be competitive and without price controls;

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<sup>7</sup> W J Baumol, *Regulation misled by misread theory, Perfect competition and competition-imposed price discrimination*, 2005 Distinguished Lecture, AEI-Brookings joint Center for Regulatory Studies, Washington DC, 17 March 2006.

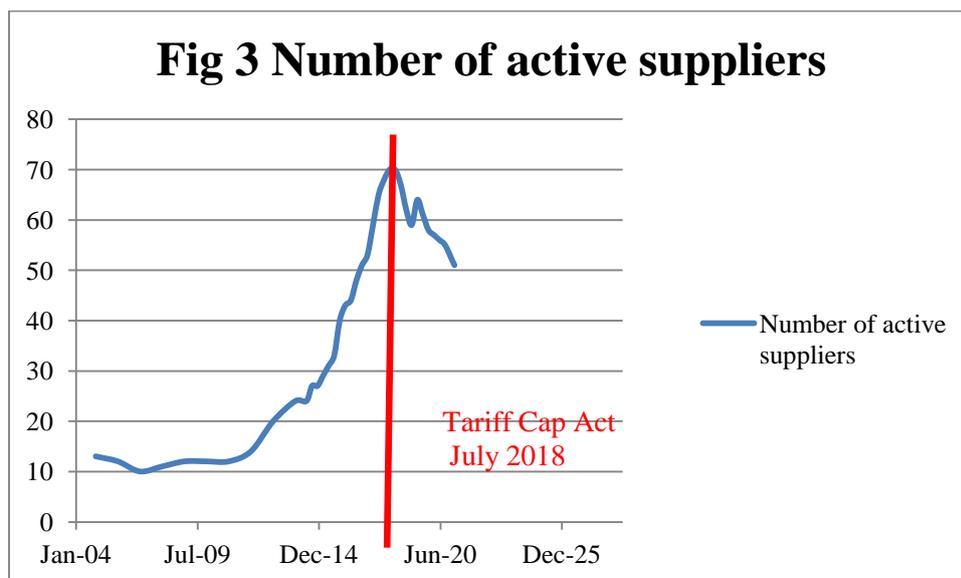
<sup>8</sup> mikewhiskeytango.com as of 12 February 2021. This group excludes the six large legacy companies, three renewable energy companies not subject to the cap, and Utility Warehouse (subsidiary of Telecom Plus, a supplier of energy, telecoms and broadband, where the energy sector profit margins are not provided separately from those of the company as a whole).

<sup>9</sup> Telecom Plus PLC, Report and Accounts, Year ended 31 March 2020, Chairman’s Statement p 7.

then suddenly a tariff cap is imposed and they are pushed into unprofitability. It is not surprising that an increasing proportion of suppliers has been unable to survive.

In the 2 ½ years from Q1 2016 to Q2 2018 just five suppliers exited the market. In contrast, in the 2 ¾ years from Q3 2018 to Q1 2021 24 suppliers exited, nearly five times as many. As in all competitive markets, some of the exiting suppliers were not sufficiently experienced, organised or funded. However, others were experienced professional companies (like Engie formerly Gaz de France, iSupply owned by Vattenfall, and Green Network Energy part of the Green Network Group in Italy since 2003), and/or backed by serious investors (like Tonik backed by Mitsui).

Figure 3 shows the number of active suppliers in the market from 2004 to date (per Ofgem data portal with estimated withdrawals since June 2020 added). It looks slightly different from the data portal graph because the latter distorts the horizontal time axis). From 2004 to 2010 the number of active suppliers was relatively constant at about a dozen. From 2010 to the first two quarters of 2018 the number rose steadily to 70. In July 2018 the Tariff Cap Act was passed. Since the Tariff Cap Act it has been downhill almost all the way, with the number of suppliers now down to around 50 and apparently still decreasing.



The tariff cap experience is sending a clear message to investors: the UK retail energy market is now politicised and subject to severe price controls, the political risks outweigh the economic risks. It is a market that prudent investors are exiting rather than entering.

By imposing and continuing an explicitly severe tariff cap, Government and Ofgem bear some responsibility, not only for the short-term distress caused to customers of those suppliers that have been forced out of the market by the artificially low regulated prices, but also for the longer term adverse consequences of discouraging new entry, innovation and investment.

### **13. Tariff cap supported by some suppliers**

Some significant suppliers have nonetheless publicly supported the tariff cap. In particular, several of the former medium suppliers that Ofgem now classes as large suppliers – call them the New Large suppliers – have been critical of the inefficient costs of the Old Large suppliers, and of the so-called ‘loyalty tax’ imposed by these latter suppliers by virtue of the significant differentials between their higher Standard Variable Tariffs and their lower fixed tariffs. They have supported a tariff cap to protect these loyal customers. So if some suppliers themselves support the tariff cap, can one really object to it?

The New Large suppliers are some of the most impressive participants in the present retail market, for example in terms of their efficiency, innovation and boldness of approach. They have been pro-active environmentally. For the most part they have adopted relatively uniform pricing policies that treat customers more equally, some having only one tariff, others a variety of fixed and variable tariffs that do not differ greatly from each other, so as not to discriminate between new and existing customers. They have grown their businesses at remarkably fast rates, and for the most part have been very highly regarded by customers and consumer bodies. And two of them have developed new customer service platforms (Octopus Energy’s Kraken and more recently Ovo’s Kaluza) that other suppliers are beginning to acquire, in the UK and internationally. This development may represent the next stage in the competitive market process in the sector.

So what’s not to like? Nothing. I much admire these companies and the people who lead them. But ... let us just ask whether their support for the tariff cap is purely a concern for the customers of other companies? Or is there perhaps more to it?

What are the main strengths of these New Large suppliers? They are the most efficient suppliers in the market, with new platforms that offer lower costs and superior customer service. They are well financed, they have significant numbers of customers, and are acquiring a good reputation and “brand”. What are some of their main commercial challenges? Consider three: to deal with the competition from their two main sets of rivals, the Old Large suppliers and the Small new entrants, and to promote the sale of their innovative new platforms.

The Old Large suppliers are less efficient and have higher costs than the New Large suppliers, but they have deep pockets and they have the bulk of existing customers, they have brand and their long-standing SVT customers are loyal to them, and they can compete by differentiating their prices. A tough tariff cap handicaps these Old Large rivals because it forces them into heavy financial losses. It doesn’t take away their existing loyal SVT customers and their brand but it expropriates the value of that asset, to the extent of up to £1.4bn – £2 bn a year. It makes it more expensive to differentiate their prices and thereby limits their ability to attract and retain the more active fixed tariff customers.

The Small new entrants do not have brand or customers or deep pockets. They depend on offering the lowest prices in the market to attract and keep customers. A tough tariff cap handicaps them because it limits their ability to undercut the now-lower tariffs of most

existing suppliers, and forces them into a deeper loss-making state. It invalidates the commercially-based assumptions on which they entered the competitive market. It drives them out of the market faster than otherwise, and deters other potential suppliers from entering.

If the Old Large and Small suppliers are to survive and compete, they will need to become as efficient as they New Large suppliers. They will need to buy the new platforms that some of the latter have to offer. This is an attractive prospect for the New Large suppliers.

Of course, the New Large suppliers are themselves hit to a limited extent by the tariff cap. In the short term, their prices and profits are a little lower than they otherwise would be, and their ability to attract new customers by price cuts a little diminished. But with their lower costs and significant resources they can easily weather this temporary storm, and they have significantly better long term prospects as a result of the restrictions imposed on their rivals, the increased likelihood of being able to buy up distressed suppliers and their customers at bargain prices, and the improved prospects for their new platforms.

If companies argue for government intervention in the public interest when it is actually in their own private interest, is there anything new there? Not at all, it is to be expected. Indeed, one of Friedman's arguments against government intervention in a market, however well-intentioned, is that it would soon be turned into a vehicle for protecting and promoting the interests of particular companies in the market. Which has indeed happened with the tariff cap. So if our heroes turn out to have feet of clay, we must accept that. They are still our heroes. But let us also recognise what is going on, and the adverse and distorting effect of the tariff cap on the competitive process, and therefore ultimately on customers.

#### **14. Another CMA reference?**

What next? Ofgem and BEIS, having repeatedly emphasised that prices are £75 to £100 lower as a result of the tariff cap, now have to explain why prices will not increase by £75 to £100 if the tariff cap is lifted. Suppose that they decide to refer the matter back to the CMA to consider whether and how the retail market has changed since the last reference, and what should be done.

The CMA repeats its calculations using its hypothetical construct, a 'supplier' that is a combination of the suppliers identified as being the most competitive in the market. It finds that this hypothetical supplier has changed: it is no longer a composite of the Medium suppliers of 2015, it is now a composite of the New Large suppliers using their new low cost platforms. The efficient cost is now significantly lower than before. So other suppliers in the market are simply inefficient. At the level of the present tariff cap there is still a customer detriment of, let us say, another £1 - £2 bn per year. The tariff cap must be further tightened, by another £75 to £100 per year.

But as before there is a puzzle: why do the other suppliers not adopt the new platforms, even though the latter are more efficient? Surely it is in their interest to do so. This must be weak supplier response. These other suppliers do not know what they are doing, they are subject to

behavioural biases. They must be prodded, cajoled, incentivised to switch platforms by new regulatory opt-in or opt-out arrangements. The CMA recommends that Ofgem set up trials of such arrangements, and BEIS will legalise and impose them.

Not so, say the other suppliers, there is a rational explanation. The problem is that these New Large suppliers have a monopoly on the new platforms and they are exploiting that monopoly by charging us excessive fees to adopt their new platforms. Now the new platforms have been invented, the additional cost of making them available to other suppliers is negligible. What we need is a platform price control.

Hang on, say the New Large suppliers, this is getting out of hand. This is just a snapshot at a moment in time. The sector is gradually adopting these new platforms and becoming more efficient. We would not have entered the market and designed new platforms if we thought this was going to happen. What about the history of this market, what about the effect on the competitive market process?

We do not care about history and the competitive market process, says the CMA. Our hypothetical construct tells us that there is significant inefficiency and customer detriment that must be fixed now.

But on further thought, says the CMA, do we really want to propose a platform price control? Perhaps we do care about history and competitive market process after all. Attempting to control outcomes for the substantial majority of suppliers would run excessive risks of undermining the competitive process, likely resulting in worse outcomes for suppliers and customers in the long run. This risk might occur through a combination of reducing the incentives of some suppliers to compete by introducing new platforms and of other suppliers to engage in active choice of platforms, and an increase in regulatory risk. We believe the best, most sustainable approach to reducing this detriment in the long term is through fully competitive markets, in which more efficient platforms gradually replace less efficient platforms. So Ofgem's trials of platform switching arrangements are the way to remedy the problem, not platform price control.

But one dissenting CMA panel member is not convinced, arguing that the harm which is presently inflicted on suppliers and hence customers in this market is very severe, and the proposed trials of platform switching arrangements will take some time to come into effect, and are in any case untried and untested. This makes it risky to rely on them. That is why they must be supplemented by a wider platform price control designed to give suppliers adequate and timely protection from very high current levels of overcharging. Just for two years or so, of course. But if platform competition fails to develop, then new legislation or regulation should be introduced to drive out excessive platform pricing on a more permanent basis

The CMA's calculations of £1 – £2bn further customer detriment attract much attention, but its warning against price control is ignored. The media is aghast to discover the extent of the exploitation of customers by the further inefficiencies in this sector, and the new scandal of the monopoly position that the Large suppliers – the New ones now indistinguishable in the

public mind from the Old ones – have managed to maintain for themselves. Most political party manifestos in the May 2024 general election propose that the tariff cap should be reduced to a new lower level for several more years, and that a new platform cap be introduced. Politicians debate whether this should be an absolute or relative platform cap. The new Government is delighted to have a basis for reducing energy prices and makes implementation of both price caps a priority. Ofgem explains that energy prices are now £150 - £200 lower than they would be in the absence of these price caps.

There are further supplier exits, mergers and takeovers. The industry consolidates into six large suppliers with remarkably similar tariff policies. The 53% of voters who told the 2017 YouGov survey that they thought energy companies should be run in the public sector are confirmed in their belief. The 31% who said private sector are beginning to doubt this, and the 16% Don't Knows are beginning to think they do know after all. Most political party manifestos in the May 2029 general election propose renationalising the retail energy sector. The new Government implements this policy, explaining that from now on the loyalty penalty will be abolished once and for all because there will be one single and simple tariff for all households across the whole country. Unfortunately the Net Zero programme has had to be paused because of the lack of new investment. But on the bright side, the smart meter installation program, now due for completion by 2050, can be brought to successful termination because there is no more need for smart meters now there is a single and simple tariff for everyone.

As one of Harry Enfield's characters used to say, "Is that what you want? Cos that's what you'll get."

### **15. Opt-in and opt-out switching?**

Back to the past and present. As explained above, CMA, Ofgem and BEIS have argued that the extent of price differentials in the market – including 'loyalty taxes' - indicate that the retail market is not fully or effectively competitive, and that the reason for this is because customers don't switch enough. Hence the proposed remedy is to increase switching. The CMA got quite carried away with this, mentioning switching 4785 times in its Report and appendices.

The present proposals are for possible variants of opt-in and opt-out switching. Opt-in switching involves inviting and encouraging particular customers to switch to a nominated supplier, or possibly assisting interested customers to switch to any other supplier of their choice. Opt-out switching involves transferring customers to a nominated supplier unless the customer opts out.

Various questions and concerns have been raised about such policies. For example, Ofgem has trialled several versions of opt-in switching, and in the most 'successful' case around one quarter of the customers approached were encouraged to switch supplier. But there seems to have been no follow-up study to check whether they were happy with the new supplier. And if this approach is adopted, what is to be done about the other three quarters of customers that don't switch supplier?

To my knowledge, opt-out switching has not been used in any competitive markets, perhaps because of the implicit “consent” problem. The closest parallel is perhaps municipal aggregation in Ohio, Illinois and a few other states. But this practice has to be explicitly put to a municipality to obtain a positive vote of support in a local election. In California, Community Choice Aggregation has to be voted for by the relevant governing body of each community.

Implementation of either method on a national scale, rather than as a trial, would raise logistical issues. It would seem like a rather costly programme of work over several years.

The Ofgem trials revealed that offers were more relevant and helpful if the savings could be related to each customer’s actual usage. But that raised data protection and confidentiality issues that did not seem to be fully resolved.

As indicated earlier, customer switching in the UK is about as high as in any competitive energy market (and higher than in most other markets). It is not clear how much scope there is to increase switching, and whether any increase would be sustained over time. There seems no reason to believe that any such increase in switching would significantly reduce tariffs or tariff differentials. Some argue that either form of regulatory-organised switching would tend to discourage, rather than encourage, engagement by customers themselves.

The evidence and arguments in this paper suggest further questions and concerns. Both varieties of regulatory intervention involve Ofgem (and/or Parliament) identifying particular customers of particular suppliers that are to be encouraged to leave their present supplier. Assuming this becomes legal – not a trivial assumption, one suspects - how are these present suppliers and customers to be defined? It seems no longer feasible to target legacy suppliers, supposedly the cause or at least main beneficiaries of the problem, when some of them have been taken over by other suppliers.

So perhaps particular kinds of customers will be targeted, say those that have been on their current tariff with their current supplier for more than, say, 3 or 5 years. But what kind of message does it send to suppliers, if they are penalised for customer loyalty lasting more than 3 or 5 years? And if it is Government and regulatory policy to target suppliers’ customers with an intent to persuade them to leave, will this encourage investment by suppliers, and the “partnership between the regulator, governments, energy companies, and energy consumers” that Ofgem sees as necessary to achieve “the transition to net zero”?

How is Ofgem to choose a nominated supplier? Conventionally, by inviting suppliers to bid to supply customers at the lowest cost. But are all suppliers deemed to be suitable for all customers? The empirical evidence of Deller et al and the rough calculations noted above all indicate the different preferences of different customers, and how apparently small differences in product can lead to significant differences in savings available.

A related question is what information about the proposed new supplier(s) is to be given to customers. For example, if Ofgem chooses a small or lesser known supplier that offers a low price, will customers be told that this supplier has not been assessed by (e.g.) Which?

magazine or Citizens Advice because not enough other customers have so far chosen this supplier? Will customers be told that, on average, about four out of the ten suppliers offering the lowest prices in the market have since exited the market? Indeed, it is reported that one of the suppliers that was proposed to customers in one of the trials was at that time having financial difficulties, and left the market.<sup>10</sup>

Alternatively, if Ofgem restricts itself to promoting suppliers that are large and established enough to have been assessed by Which? and Citizens Advice, is this consistent with promoting competition and new entry? And should Ofgem take into account in its choice, and reveal to customers, that some suppliers have been highly rated by these organisations while others have not?

There are significant restrictions on the giving of financial advice – for example, an adviser must ensure that the recommended financial products are suitable for the amount of risk that the customer wishes to take. Should similar restrictions not apply when Ofgem is advising customers on the choice of energy supplier?

In sum, a variety of issues have hitherto proved somewhat controversial in the switching trials. But a national implementation of opt-in or opt-out switching would raise further issues about which suppliers and customers are to be targeted, and what information about suppliers is and should be taken into account by Ofgem, and revealed to customers. These issues look to be extremely challenging.

## **16. Getting out of the hole**

The introduction suggested that the time has come to stop digging a bigger hole, and to consider how to get out of the present one, so that Government and regulatory attention can be focused more productively. This submission suggests that, as part of its Forward Work Plan, Ofgem should include four activities:

- i) First, stop digging: move on from the incorrect narrative of an uncompetitive and inefficient retail market with significant customer detriment, and develop and communicate more broadly a better understanding of how this competitive market actually works, and why certain regulatory interventions could be beneficial but others could be counter-productive;
- ii) Second, shift the focus from trying to persuade more customers to leave their present supplier to explaining that customer loyalty is in general a good thing where it is deserved, acknowledge that although price is important it is not the only consideration, and assist customers to make informed choices of tariff and product, but also considering supplier reputation, so that customers do *not* need repeatedly to switch supplier;

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<sup>10</sup> “The regulator has since revealed that SSE wrote to customers and listed Electraphase, a company unable to pay its debts, as one of the alternatives. It has been reported that SSE sent more than 176,000 letters to customers, with almost 13,000 of these suggesting a switch to Electraphase.” Adam John, *Utility Week*, 14 August 2018. Electraphase went into administration in August 2018.

- iii) Third, if collective switching is to be considered, use it as a means of discovering the competitive price for serving particular kinds of vulnerable customers, with the emphasis on products to meet their needs, and working with existing suppliers rather than against them;
- iv) Fourth, develop a strategy to remove or relax the present tariff caps, and at least ensure that a convincing case can be made for not renewing them at the end of 2023.

The earlier material in this submission has sought to provide the basis for the first task. It is basically a matter of acknowledging various competitive aspects of the market, and various limitations of regulatory intervention, that have not been fully acknowledged in recent years.

The next three sections develop briefly the suggested activities.

### **17. Assisting informed choices**

The second task has two main aspects. The first aspect is to recognise that the CMA analysis has been superseded by further empirical research by economists, not least by Deller et al, which indicates that energy is not a homogeneous product, that there are in fact many different products in the market, and that different customers have different preferences as between these different products. Hence customers are not guilty of weak customer response, they are making rational economic choices that should be respected. And when customers find a supplier that provides what they want, and continues to do so over time, they should be encouraged to be loyal rather than disloyal.

The second aspect is to realise that finding a supplier that provides what they want is not as straightforward as with finding a supermarket, for example. Customers cannot easily pop in and try a new supplier one afternoon. But this is nothing new, and the market has a particular way of discovering and conveying to others which firms or products have, over time, established themselves as more or less satisfactory in the eyes of customers. That way is via reputation.

As indicated above, Uswitch has established empirically, on the basis of actual switching data, that Large suppliers have a more recognised brand than Medium suppliers, which in turn have a more recognised brand than Small suppliers. But size – number of customers acquired or retained – is not the only potentially relevant consideration for customers.

It would seem helpful for customers to be able to know, in a simple way, what other customers and customer organisations think about the various suppliers in the market. Of course, each customer and each organisation will have its own preferred criteria for judging a supplier. Rather than inundating customers with all these views, and rather than declaring just one of these the best or most relevant criterion, why not take an average of them? Suppliers that come out top are those that have demonstrated the greatest ability to provide all-round customer satisfaction.

Specifically, I have proposed the calculation of an Overall Customer Satisfaction (OCS) score.<sup>11</sup> This is the average of four individual scores related to data or ranking published by Ofgem (on customer complaints), Citizens Advice, the Consumer Association's Which? magazine, and customers' own views as expressed on Trustpilot. Just over two dozen suppliers are typically in the OCS league at any time – about half the total number of suppliers. These are the suppliers that have proved their ability to attract or retain a significant number of customers. Within this league, some suppliers have attracted more supportive ratings than others, some have been increasing their ratings, others have been falling.

No doubt there are other approaches worth considering. The simple aim is to develop and make available information that could be helpful in establishing more quickly the reputations of suppliers, so that customers (and regulators) can be more confident that customers are making informed choices whether to be loyal to particular suppliers, or which suppliers to turn to if they are considering switching.

### **18. Collective switching to discover competitive prices for vulnerable customers**

In July 2019, Ofgem and then-CEO Dermot Nolan indicated that “a replacement for the price cap is Ofgem's absolute priority over the next few years”. I suggested 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”.<sup>12</sup>

Briefly, the idea was to discover whether the prices to certain sets of customers, particularly vulnerable customers, were in fact higher than the efficient cost of providing service to these customers, or whether, as the existing suppliers often argued, the costs of serving these customers were greater than the costs of serving other customers. Rather than a tariff cap that would depend upon regulatory judgement about costs and appropriate returns, the idea was to use a competitive tendering process to establish a reasonable competitive price for particular sets or types of customers.

This would involve inviting suppliers to bid to serve specified sets of vulnerable customers, taking particular account of quality of service considerations, and the particular needs and preferences of these types of customers. It is possible that the lowest prices bid would not be significantly lower than the present tariffs of these customers, in which case it would not be necessary to go further. Also, there would be an opportunity for a potential new supplier to

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<sup>11</sup> S C Littlechild, “An overall customer satisfaction score for GB energy suppliers”, EPRG Working Paper 2027, September 2020, at <https://www.eprg.group.cam.ac.uk/wp-content/uploads/2020/09/2027-Text.pdf>, and “Developments in the Overall Customer Satisfaction league”, Cornwall Insight, Energy Spectrum, Issue 745, 18 January 2021, at [https://www.eprg.group.cam.ac.uk/wp-content/uploads/2021/01/S.-Littlechild\\_Cornwall-Insight\\_Jan2021.pdf](https://www.eprg.group.cam.ac.uk/wp-content/uploads/2021/01/S.-Littlechild_Cornwall-Insight_Jan2021.pdf)

<sup>12</sup> Stephen Littlechild, “Replacing the tariff caps and protecting vulnerable customers by harnessing the competitive process”, University of Cambridge Energy Policy Research Group, 18 July 2019, at [https://www.eprg.group.cam.ac.uk/wp-content/uploads/2019/07/S.-Littlechild-Replacing-the-tariff-cap\\_17Jul19.pdf](https://www.eprg.group.cam.ac.uk/wp-content/uploads/2019/07/S.-Littlechild-Replacing-the-tariff-cap_17Jul19.pdf)

negotiate the transfer of customers by agreement with the existing supplier, thereby avoiding the expropriation of the value of loyal customers.

Over time, experience would indicate what broad levels of tariffs are competitive for particular sets of vulnerable customers, and suppliers would be able to adjust their own tariffs accordingly, in order to obviate the need for extensive regulatory intervention and tendering out.

Whether any variant of mandatory collective switching is appropriate needs careful consideration, given the increasing evidence that “weak customer response” is a too-simplistic characterisation of energy customers. But if it is appropriate, something along the above lines seems worth consideration. Throughout, the aim should be to provide personal assistance to the vulnerable customers, with the focus on finding the products, tariffs and suppliers that are most appropriate for these customers, rather than on maximising the number of customers switching supplier.<sup>13</sup>

### **19. Removing or relaxing the tariff caps**

The fourth suggested task is to develop a strategy to remove or relax the tariff caps, and at least ensure that a convincing case can be made for not renewing them at the end of 2023. A replacement process has just been suggested in the previous section. But will such a process, which might seem rather abstract, be persuasive?

When Ofgem and the Secretary of State come to review the tariff cap at the end of each year, one would assume that a key question in their minds – because it will be put to them - is: will energy prices go up if the tariff cap is removed? If so, Ofgem and the Secretary of State will appear to have misjudged the situation and made the wrong decision. To be on the safe side, better find that the market is not yet competitive, and kick the can down the road. On that basis, the tariff cap will never be removed until 2023, and by similar reasoning Government will then feel obliged to pass a new Act to continue the tariff cap for several more years.

The suggestion here is that the calculations underlying the setting of the tariff cap be modified to ensure that, by the end of 2023 at the latest, the competitive retail market is already operating with all or most of the tariff prices below the tariff cap (excluding renewable products). Then discontinuing the cap cannot be expected to lead to the feared sudden increase in prices. Indeed, Ofgem and the Secretary of State can point to the successful restoration of competition in the retail energy market.

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<sup>13</sup> A similar point has been made elsewhere: “Are we happy with the current paradigm, where success is measured by the number of switches and harm is protected by the price cap? ... Or should we be aiming for one where retailers are not just providers of commodity, but providers of services, with a much richer relationship with their consumers, a market that tries to explore and understand what people actually want from their energy, and where suppliers get rewarded fairly if they are able to meet those demands?” Guy Newey *Devolving power: strategic choices for the future Net Zero energy system*, 11 February 2021, at <https://t.co/xUZ24m8HDY?amp=1>

How might this be done? I have elsewhere suggested a simple method.<sup>14</sup> Estimate the extent to which the highest prices (at the cap level) are below the level that would obtain in an unrestricted competitive market. Then increase the cap by a specified amount each time it is reset, so that by the end of 2023 at the latest, the cap has reached this level.

For example, Ofgem and BEIS refer to the cap saving £75 to £100 a year, figures also used in the CMA report. For the sake of argument, assume £75, on the basis that the unrestricted market prices in future would be lower than in 2016 or January 2019 because of subsequent increased efficiency of the former large suppliers, and stronger competition in the market.

Note that there are five more occasions on which the tariff cap will need to be reset if it is not removed before December 2023. So on each of these occasions, calculate the tariff according to the present Ofgem process, but add £15 cumulatively at each resetting. Then by October 2023 the cap will be at a level such that no further tariff increases can reasonably be expected (other than to reflect legitimate cost increases) if the tariff cap is not renewed.

In practice, of course, it is entirely possible that suppliers will gradually find it profitable to price below the cap before it is increased by the full £75. Then Ofgem and BEIS can point to the successful reintroduction of competition, and indeed can consider repealing it before the end of 2023.

There are of course other less overt ways of achieving the same end. For example, the calculation of 'efficient cost' might gradually transition from the CMA's unrealistic perfect competition concept to a more realistic assessment of what could have been achieved by the highest cost suppliers in, say, 2016 or 2019. I understand there are many controversial elements of the present 'efficient cost' calculation where costs are said to have been underestimated or omitted, and a case could be made for a higher figure.

Is there a legal basis for such an approach? There appears to be no barrier. The Act does not require Ofgem to make the same calculations each time, and indeed Ofgem has continually varied its calculations.

Nor does the Act restrict Ofgem to the four new considerations mentioned in the Act. They are simply considerations to which Ofgem has to have regard in discharging its wider statutory duties. It still has a duty to protect the interests of customers, "wherever appropriate by promoting effective competition"; the retail market is one area where it certainly is appropriate to promote effective competition; and at this stage of market development the gradual relaxation of the tariff cap is an appropriate way to do so.

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<sup>14</sup> Stephen Littlechild, "Providing for a transition back to a competitive retail energy market: A response to the CMA's Invitation to Comment on its proposed review of the Prepayment Charges Restriction Order 2016", 17 January 2019, at [https://www.eprg.group.cam.ac.uk/wp-content/uploads/2019/06/S.-Littlechild\\_Energy-Prepayment-Review-submission-to-CMA\\_1Jul19.pdf](https://www.eprg.group.cam.ac.uk/wp-content/uploads/2019/06/S.-Littlechild_Energy-Prepayment-Review-submission-to-CMA_1Jul19.pdf)

## **20. Conclusions**

The arguments and suggestions herein are not at variance with the aim and intent of Ofgem's proposed Forward Work Plan. Rather they are suggestions for better enabling their achievement.

If it is Government and regulatory policy artificially to hold down prices and profits, and to target suppliers' customers with an intent to persuade them to leave their suppliers, this will not encourage investment by suppliers, and the "partnership between the regulator, governments, energy companies, and energy consumers" that Ofgem sees as necessary to achieve "the transition to net zero".

Instead, a replacement for the tariff cap is a key priority, because a continuation of the tariff cap regime is not conducive to achieving the aims of the Forward Work Plan. To replace the tariff cap requires i) correcting the historical and present narrative about the nature of the retail market, ii) shifting the focus from switching supplier to finding and staying with the right supplier, iii) trying to find and ensure competitive prices for vulnerable customers by using the competitive process rather than by tariff caps, and iv) providing for a gradual transition to the removal of the tariff cap, so that customers and the electorate can plausibly be assured that prices will not rise significantly once the tariff cap is removed.