

Professor Stephen Littlechild

**The following is an outline of Stephen Littlechild's response to BEIS and Ofgem consultations on the retail energy market. Stephen is Emeritus Professor, University of Birmingham; Fellow, University of Cambridge Judge Business School; and former Director General of Electricity Supply.**

The rapid, significant, and unwelcome increase in energy prices at the end of 2021 posed important and urgent questions. Notably, how best to help lower income and vulnerable customers cope with this? Many different solutions have been proposed. However, continuation of the energy price cap should not be one of them.

Has the price cap protected customers from higher price increases? Not really. Customers don't pay lower prices overall. The cap simply kicks the can down the road. Later this year, and perhaps next year too, customers will have to pay higher prices than they otherwise would have done.

If the price cap had simply smoothed prices over time, there might have been no great objection. But it has actively contributed to the failure of nearly fifty suppliers. Under Ofgem's rules, this imposes costs of billions of pounds on customers generally.

The price cap has also wrecked what was arguably the most vibrant competitive retail energy market in the world. Suppliers don't want to sell and customers don't want to buy.

The price cap was introduced as a temporary measure, to expire in December 2023 at the latest. The government now proposes legislation to renew it. But to rescue the competitive market, and the prospect of the private sector investment and innovation needed to meet net zero, precisely the opposite policy is needed: to remove the price cap as soon as possible.

### **The price cap was a mistake**

Why did Parliament impose a price cap? The CMA investigation found in 2016 that many customers did not switch to suppliers with lower price tariffs. It deemed this "weak customer response". But it advised against a price cap, instead recommending that Ofgem try to increase customer switching.

In fact, customers had various reasons for not switching to the lowest price tariff. Sometimes the products were different and less suitable, sometimes the quality of service was not as highly rated. Also, as is now apparent, some of the lower priced suppliers were riskier, less well financed and less well-known. In retrospect, customer response seems to have been prudent rather than weak.

The CMA then made a more serious mistake. To quantify the extent of customer detriment caused by the alleged weak customer response, it compared the existing level of prices with an implausible level of competitive price, equal to the lowest cost in the market. The CMA calculated this detriment to be £1.7bn - £2bn per year.

This was simply wrong: inconsistent with elementary economics, with previous UK competition authority practice, and with the CMA Guidelines. Not surprisingly, however, this calculation was cited in the 2017 election manifestos, along with commitments to introduce a price cap. The die was cast.

### **Would competition be effective?**

Ofgem, too, had argued against a price cap. But legislation now required it to administer the cap, and to review annually whether conditions were in place for effective competition. This put Ofgem in a difficult position, requiring it to assume that competition was not previously effective and to invent conditions to be met.

Ofgem's analysis has not been persuasive. Condition 1 was that structural changes, such as smart meters and faster switching, should facilitate competition – but such changes are not critical to competition. Condition 2 was that competition should work well in the absence of the price cap – but properly understood competition was already working well. Condition 3 was that the competitive process should deliver fair outcomes – but no

economist believes that. Ofgem explained that “fair” meant no inefficient costs or excessive profits. But some companies are less efficient than others in all competitive markets, and the sector has long been predominantly loss-making.

A conventional economic analysis would have deemed the market effectively competitive. Indeed, has any other residential energy market been more competitive?

### **Impact of the price cap**

Ofgem feared that a price cap would cut the price savings available in the market and thereby reduce switching by 33% to 50%. But initially, substantial price savings were still on offer, perhaps even higher than before, and the switching rate remained high.

However, this was because the cap was set in advance, and wholesale prices were steadily declining. The cap might also have encouraged some suppliers to price higher than they otherwise would have done.

During 2021 wholesale prices began increasing rapidly, the price cap now became tighter than intended, and price savings reduced then disappeared. Suppliers are now forced to post a variable tariff at the price cap level, but don't want to supply or attract customers at that price. A few suppliers still offer fixed tariffs at significantly higher prices than the cap, but customers don't want to buy at those prices. Switching is at a record low. Commercial switching businesses have closed down.

The average profit (EBIT) of the six large legacy suppliers fell from around 4% over 2012 – 2017, and below 3% in 2018, to -1.5% in 2019 and -1% in 2020. For two dozen other non-legacy and non-renewable energy suppliers, the average profit margin from 2019 or later was -11% as of February 2021 and is surely even lower now.

From 2004 to 2010 the number of retail suppliers in the domestic energy market was relatively constant at about a dozen. From 2010 to the Tariff Cap Act in July 2018 the number rose to around 70. Since then, nearly 50 domestic suppliers have gone bust, while others have sold out. This is no longer a market to enter, it is a market to leave.

Nearly 5mn customers were transferred to another supplier because their own supplier had gone bust. Their credit balances, and various social and environmental obligations, were protected, but at the expense of other customers, totalling several billion pounds.

The price cap is not the only factor. However, there have been comparable increases in wholesale energy costs elsewhere – for GB business customers, and for domestic customers throughout Europe – without comparable exits of suppliers or drying up of markets.

Without a price cap, there would have been greater price increases over the last year. Some underhedged or underfunded suppliers would still have exited. But suppliers would still have competed on price, switching would have continued, customers would still have had choices and would not have been locked into their present supplier. In short, the competitive market would not have been destroyed.

### **Government retail energy market strategy for the 2020s**

The government proposes a market to enable net zero, where energy companies invest in innovative products and services, and competition gives the right price signals for the update of low-carbon products and services.

However, the price cap has, in effect, unleashed a bull in a china shop. What's more, the government has indicated that it wishes to keep the bull in the shop after 2023. A shopkeeper with any sense will try to salvage any undamaged china and get out of the shop as soon as possible. To expect any shopkeeper to invest in further china to restock the shop while the bull is still there, let alone go to the expense and risk of discovering and offering innovative new ranges of china, is a delusion.

The precondition for achieving the strategy aims is to remove the price cap as soon as possible, perhaps by adding a predetermined amount at each remaining resetting. Suppliers must want to enter the market rather than leave. They must be rewarded for satisfying their customers and for innovating in a way that is conducive to moving to net zero.

### **Ofgem and financial risk management**

Ofgem has proposed stricter standards of financial resilience for suppliers. This assumes that it was inadequate hedging by suppliers, not the price cap, that primarily caused the failures. As of yet this is not

clear. It also assumes that regulators know best and are willing and able to prescribe and enforce appropriate standards and update them as underlying market conditions change. This is optimistic.

Competition is process for discovering, over time, what kinds of hedging and credit control arrangements are most cost-effective. An alternative approach would be to encourage greater roles for market participants.

If suppliers were required to hold a minimum amount of risk capital, the providers of this capital would have a strong incentive to monitor the supplier's procedures. If customers were warned about unproven suppliers, instead of urged to choose the lowest price, they would require more evidence of suppliers' ability to survive unexpected market conditions. If suppliers had to provide more information about their financial position, consumer bodies could form their own judgements and advise customers accordingly.

### **Ofgem's possible short-term interventions**

Ofgem is considering potential short-term interventions to address risks from market volatility. However, the price cap adds new risks, including by preventing suppliers from adjusting their prices to the volatile costs.

Should suppliers have to make all new tariffs available to existing customers? The stated aim is to reduce their incentive to reduce their prices to attract new customers, thereby reducing supplier losses from higher churn. If Ofgem wants to be the only regulator in the world trying to stop competitors from reducing prices, this is the route to take. But eliminating the price cap, with its higher costs and risks of customer churn, is the more obvious and sensible solution.

Should Ofgem "require all suppliers acquiring a domestic customer to pay a 'Market Stabilisation Charge' to the losing supplier"? This reversal of previous policy would adversely affect competition. Again, the "problem" that it seeks to address has essentially been caused by the price cap.

In contrast, allowing suppliers to charge exit fees on some Standard Variable Tariffs would be sensible. As Ofgem says, "Exit fees are common in other sectors where firms take on price risk for consumers, for example, fixed-rate mortgages." It would indeed be "a departure from Ofgem's previous policy position". But that is a position for which, on reflection, there seems inadequate justification.

In all three cases, the proposal that significant changes in regulation should apply for just a few months in 2022, but may (or may not) be extended, suggests an obliviousness to the cost, uncertainty, and confusion that such temporary changes would cause. As well as, again, a failure to acknowledge that it is primarily the price cap that is causing such havoc and distortion in the market.

### **Conclusion**

For years to come, the destruction of the GB competitive retail energy market will be a standard textbook example of the unintended adverse consequences of a price cap.

The challenge now is to revive the competitive market before it dies. A prerequisite is to remove the price cap and to find constructive rather than destructive ways of protecting vulnerable customers. All customers need the benefits of competition, with the associated willingness to invest and constant search for greater efficiency and innovative products and services that better meet customer demand. The prospect of achieving net zero without a profitable and customer-oriented competitive market seems remote.

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