The importance of terminating the energy price cap:
a response to BEIS and Ofgem consultations on the retail energy market

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1. After possibly the most dramatic few months in the history of the GB retail energy market, the Government (BEIS) is reconsidering its retail energy market strategy and has called for evidence on the future of this market. The BEIS Parliamentary Committee has launched an inquiry into energy pricing and the future of the energy market. Ofgem is consulting on several measures to build energy market resilience including stronger financial regulation, adapting the price cap methodology and some short-term interventions to reduce risks to consumers. There is also extensive public discussion about how best to protect customers, especially vulnerable customers, from the present very high energy prices.

2. The present submission to the BEIS and Ofgem consultations argues that the energy price cap has had very serious adverse effects on competition and hence on customers. Quite simply, it has destroyed the market. Consequently, a precondition of any policy to recreate any kind of future energy market must be the removal of the energy price cap. The Government should therefore not seek to legislate to extend the price cap beyond December 2023. On the contrary, the Government and Ofgem should take steps to facilitate its removal by December 2023 at the latest.

3. The Government has recently said that "Three principles have consistently guided the Government's response. Customers, and particularly vulnerable customers, should be protected. We will not be bailing out failed companies with poor business models. And we must not return to the cosy oligopoly of the past." (Written ministerial statement to Parliament by BEIS Secretary of State, 15 December 2021) The price cap is not required in order to achieve any of these three principles, nor would discontinuing or not renewing the price cap be inconsistent with them.

4. The same statement said that the Government "remains committed to seeking to legislate to extend the energy price cap beyond the existing longstop date of December 2023, when parliamentary time allows, subject to conditions for effective competition not being in place". Removing or not extending the price cap would not be inconsistent with this commitment, because removing the price cap would enable "conditions for effective competition" to be in place. Before the imposition of the price cap, competition already was effective. The view that it was not effective was the result of the flawed CMA 2016 calculation of customer detriment. At present, the only impediment to effective competition is the price cap itself. Removing the price cap is precisely the measure needed to achieve effective competition.

5. This emphasis on removing the price cap is not to preclude or downplay the importance of taking action to protect vulnerable customers. Various suggestions have

been made, including reducing or suspending VAT or other taxation, increasing and/or extending the Warm Home Discount scheme, increasing Winter Fuel Payments or Cold Weather Payments, suspending low carbon levies or shifting the burden to general taxation, deferred payment of network charges, deferred recovery of Supplier Of Last Resort charges, Government-backed loans to suppliers or network companies, and several other measures. These largely political decisions are not the subject of this submission, and none of them requires the continuation of the energy price cap.

OUTLINE PART ONE CORRECTLY UNDERSTANDING THE CONTEXT

6. The CMA could not understand why some customers failed to switch to lower priced tariffs and called this “weak customer response”. In fact, customers were aware of differences in product and in supplier, not least, as has now become apparent, that new and unknown suppliers were riskier than well-known ones. The unduly blinkered drive to increase customer switching has been misguided.

7. The election mandate for a price cap was driven by the mistaken calculation of £1.7 - £2 billion customer detriment in the 2016 CMA Report. In reality, there was no such detriment. Retail competition was effective then and would be effective now in the absence of the price cap.

8. Ofgem was put in a difficult position by the Tariff Cap Act, which assumed that competition was not effective. Ofgem proposed three tests of effectiveness, which it has not yet found to have been met. These three tests have little or no economic basis and are largely irrelevant to the question of whether competition is effective.

9. BEIS and Ofgem discussions of present and future experience and policy have ignored or underestimated the adverse impact of the price cap. With initially falling wholesale prices, the price cap seemed benign. But in the context of rising wholesale prices the cap has been nothing short of a disaster. It has imposed additional restrictions, risks and costs on suppliers, thereby causing or materially contributing to the failure of nearly fifty suppliers. Under Ofgem’s arrangements this in turn imposes heavy costs on customers. Quite simply the price cap has destroyed the competitive market: there is now a regulated variable tariff price at which suppliers don’t want to sell, and a few unregulated fixed tariff prices at which customers don’t want to buy. The price cap has prevented competition from working, removed effective customer choice and replaced it by heavy-handed and inflexible regulatory dictat.

OUTLINE PART TWO RESPONSE TO THE BEIS CONSULTATION

10. The present submission does not argue against the general concept and aims of the Government’s proposed retail energy market strategy for the 2020s. It focuses on a small number of important issues.

11. The Government wishes to attract new investment. The price cap has in effect unleashed a bull in a china shop. There is no prospect of suppliers restocking the shop, or trying to discover and provide what kinds of china customers like best, or

would be most consistent with net zero, as long as the bull is still in the shop and the Government is proposing to keep it there.

12. The Government does not wish "to return to the cosy oligopoly of the past". However, although there were only six main suppliers in the market from 2004 to 2012, the market was never "cosy". Moreover, for the last decade there has new entry on an increasing scale, with entrants' market share increasing from 1% at end-2010 to about 15% in early 2015, about 30% by late 2019 and about 45% by mid-2021. Early removing of the price cap could enable a return to a vibrant competitive market. Retaining it would freeze market shares and preclude competition and new entry.

13. A previous (July 2021) BEIS policy intention was to use opt-in switching, and trial opt-out switching, in order to tackle the 'loyalty penalty'. But many supposedly irrationally loyal customers were in fact prudently sticking with suppliers they knew. Some suppliers previously adopted a single tariff, or a set of tariffs at similar prices, with a view to avoiding a loyalty penalty. However, the number of suppliers doing so has fallen over time, most customers do not seem to have felt strongly about this differential, and many of the suppliers adopting this policy have now gone bust or otherwise left the market. To prohibit or discourage widely differential prices would favour some suppliers at the expense of others, and limit competition to the detriment of customers generally, for a policy that is not obviously commercially viable and that is not obviously valued by most customers themselves.

14. Opt-in and opt-out switching schemes are risky insofar as they attempt to change the decisions of customers, which recent events have suggested are more soundly based than the advocates of such measures realised. They are unnecessary and undesirable as a means of making the retail market more competitive. Whether they are justifiable for particular vulnerable customers, or for purposes of net zero, requires further consideration. But the risks to suppliers from a continuation of the price cap will surely deter their participation in such schemes.

OUTLINE PART THREE RESPONSE TO TWO OFGEM CONSULTATIONS

15. The Ofgem consultation on milestone assessments and reporting requirements makes proposals for more severe measures. This places Ofgem centre stage, increasingly responsible for determining financial risk arrangements in the market. There is decreasing responsibility for suppliers and no acknowledgement of the role of customers, who look for evidence of financial viability and survival over time rather than regulatory rules.

16. The consultation perspective and proposal have two main drawbacks. First, in reality, regulators are not very good at designing, implementing and revising such rules. They lack the required first-hand knowledge of (ever-evolving) market conditions. Ofgem might therefore wish to provide further information to customers about the actual financial arrangements of each supplier, so that customers and organisations that represent them can provide advice that customers can consider.

17. Second, the consultation makes almost no reference to changing market conditions. Astonishingly, it makes no mention at all of the price cap. Yet the price

cap has increased costs and risks to suppliers, compromised or invalidated their previous business models and helped to drive some 45 suppliers out of the market, at very considerable cost to customers. So the existence of the price cap, and Ofgem's setting of it, have been a major contributor to the present financial problems and the associated costs, risks and other harms to suppliers and customers.

18. Ofgem and the Government can significantly reduce those costs, risks and harms by relaxing and then removing and not renewing the price cap. That will have greater and more significant benefit than any modifications to the financial risk management regulations.

19. Recent events and present conditions are not typical of a competitive market. They reflect a competitive market that has not been allowed to respond to underlying changes in market conditions, and in the process has temporarily, at least, been destroyed by the price cap. Requiring suppliers to adopt financial risk arrangements based on ability to withstand such a price cap would increase costs and restrict competition significantly and unnecessarily, to the disadvantage of customers - if indeed any suppliers were willing to enter and operate in such a market.

20. The Ofgem consultation on potential short-term interventions explains the present difficult situation for suppliers, but fails to explain that this situation has been created, or at least exacerbated, by the price cap. The proposed interventions are basically to try to stop change. They suggested a worrying lack of appreciation of the nature of the problem and its obvious solution.

21. The stated aim of the first proposed intervention – to make all new tariffs available to existing customers – is to reduce the incentive of suppliers to attract new customers. If Ofgem wants to be the only regulator in the world trying to stop competitors from reducing prices, this is the route to take.

22. The third suggested intervention would require all suppliers acquiring a new customer to pay a market stabilisation charge to the losing supplier. This would be directly opposite to Ofgem's long-standing policy of encouraging competition. Both these two interventions would be blatantly anti-competitive.

23. In contrast, the second suggested intervention – to allow suppliers to charge exit fees on some Standard Variable Tariffs – would be sensible.

24. In all three cases Ofgem proposes that these significant changes in regulation should apply for just a few months in 2022, which might – or might not - be extended. This suggests an obliviousness to the cost, uncertainty and confusion that such temporary changes would cause. And again a failure to realise that it is the price cap, rather than the unprecedented wholesale price increases, that are causing such havoc in the market.

25. Finally, to emphasise again, this submission is not arguing against protecting vulnerable customers. Various ways to do this have been suggested and debated by others. Rather, this submission argues that the price cap is a particularly costly and destructive way of attempting to protect vulnerable customers. Continuation of the price cap is inconsistent with the survival of a competitive market and with attracting the new investment and innovation that will be necessary to deliver any net zero policy.

PART ONE CORRECTLY UNDERSTANDING THE CONTEXT[1]

Mistaken diagnosis of weak customer response

26. In 2014 the CMA was asked to investigate the energy sector. It found most of the sector competitive, but was puzzled to find that some customers, including many lower income customers, did not switch to other lower priced tariffs available. Influenced by previous government and regulatory thinking and policy on behavioural economics, it called this "weak customer response", and urged Ofgem to encourage customers to switch suppliers more frequently.

27. There are, however, several good reasons why not all customers would switch supplier to apparently lower prices. The products offered are not all identical. For example, some lower priced tariffs are online only and do not offer paper bills, or are less "green".

28. Nor are the suppliers identical: some offer better support to vulnerable customers. Some are rated higher than others by Which? magazine or Citizens Advice, or have better complaint ratios. I have elsewhere proposed an Overall Customer Satisfaction index that might better inform customers of the wider picture.[2]

29. Importantly, there is evidence that customers prefer suppliers that they know or recognise, and are more willing to switch to them. Brand matters.

30. Recent events suggest that customers' instincts are valid. Many low-income customers, in particular, who are not in a position to take risks, preferred tried and tested suppliers to new and unknown suppliers that they feel have a higher risk of going bust. Such customers were indeed prudent: none of the original Big Six suppliers have gone bust, while nearly 50 new suppliers have done so.

31. In short, experience suggests that the CMA was wrong, and customers were right. This undermines the CMA view that competition was rendered less effective in the retail market because of weak customer response. It also calls into question the subsequent policy of focusing almost entirely on increasing switching, with little or no regard for differences in quality of product and soundness of supplier, and the view that increased switching is a prerequisite for effective competition.

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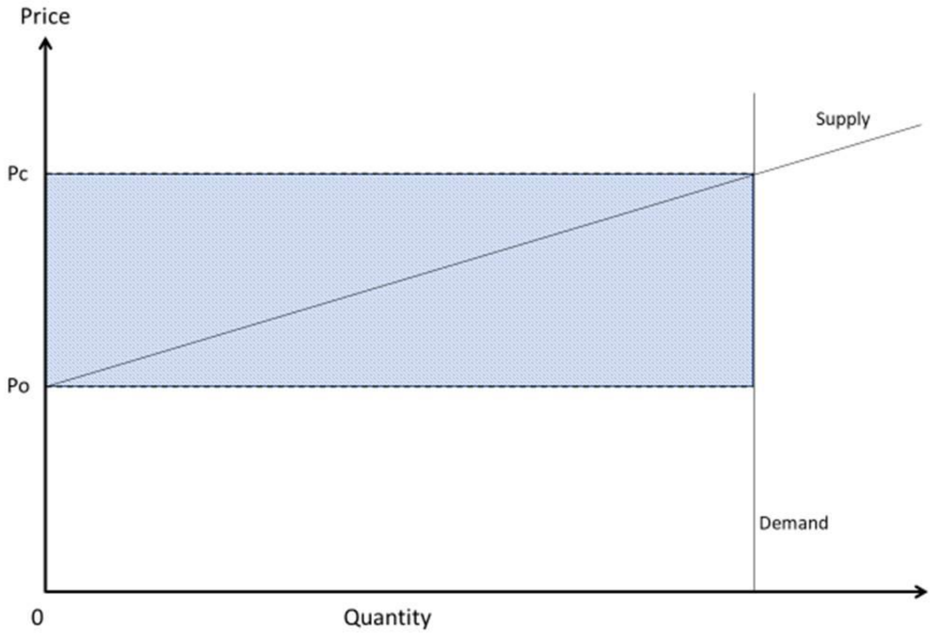
[1] Many of the arguments in this Part One are set out at greater length in my published article "The challenge of removing a mistaken price cap", *Economic Affairs*, Vol 41 No 3, October 2021, pp 391-415. A pre-proof copy is available here https://www.eprg.group.cam.ac.uk/wp-content/uploads/2021/09/S.-Littlechild-Economic-Affairs_Oct2021.pdf with a link to the final publication here https://onlinelibrary.wiley.com/doi/abs/10.1111/ecaf.12498

[2] "Exploring customer satisfaction in the GB retail energy sector: Part III A proposed Overall Customer Satisfaction Score", *Utilities Policy* Vol 73, December 2021, pre-proof copy available at https://www.sciencedirect.com/science/article/abs/pii/S0957178721001338?dgcid=author A recent update is in the Nutwood section of Cornwall Insight's *Energy Spectrum*, Volume 744, 6 December 2021 pp 21-2, available here https://www.eprg.group.cam.ac.uk/wp-content/uploads/2021/01/S.-Littlechild_OCS_Dec2021.pdf

Mistaken calculation of customer detriment

32. The CMA then sought to estimate the magnitude of the customer detriment that it assumed was caused by weak customer response. Its approach can be represented diagrammatically in the form of the simple Supply and Demand diagram familiar from A level economics onwards.



33. The competitive price Pc is determined by the intersection of the Supply and Demand curves. (For simplicity the Demand curve is shown in this Diagram as inelastic hence vertical.) A price above that intersection indicates customer detriment. This is how UK competition authorities have calculated customer detriment in the past, and quite explicitly so in the 2014 Competition Commission report on the cement market.

34. However, the CMA decided that the competitive price in the energy market was Po, the unit cost of the lowest-cost supplier in the market. Hence the customer detriment was the whole area shaded: the difference between Po and Pc, multiplied by the total output in the market. Which the CMA calculated to be £1.7 - £2 billion per year. This was said to be a combination of excess profits (the shaded area above the supply curve) and inefficient costs (the shaded area below the supply curve).

35. This was simply wrong. The CMA panel would have flunked A level economics. And as noted its approach was inconsistent with previous UK competition authority practice.

36. The CMA explained that it was using a "hypothetical construct, a 'supplier' that is a combination of the suppliers that we have identified as being the most competitive in the market". But use of such an "idealized perfectly competitive market" is explicitly ruled out in the CMA *Guidelines*. It begs the question of what trust can be placed in these *Guidelines* if they are so blatantly flouted.

37. If the CMA had used a correct and conventional approach, it would not have found a customer detriment of £1.7 - £2 billion per year. Using a more conventional excess profit approach (see footnote 1), it might have found a customer detriment of an order of magnitude less, perhaps around £7 per customer per year. Such a detriment would certainly not have justified – or led to demands for - an extreme 'remedy' such as a price cap, if indeed it would have merited any remedy at all. Thus, there was no reason to believe that competition was not broadly effective when the CMA analysed the energy market.

Ofgem tests of effectiveness of competition

38. When prices rise in a regulated competitive market, regulators and Governments feel under pressure to Do Something, at least if they are unable to demonstrate that the price increases are justified by underlying cost increases outside the control of the competing suppliers. These actions are generally later found to be inappropriate. There have been four recent examples of this when prices have risen in the UK retail energy sector (as reflected in Ofgem's data on Large legacy suppliers – Domestic dual fuel bill breakdown over time). Thus

- 2008-9 price increases led to Ofgem's Non-discrimination condition, which the CMA later accepted as having reduced competition
- 2011-13 price increases led to Ofgem's Simple Tariffs policy, which again the CMA later found to have an adverse effect on competition
- 2017-18 price increases following CMA £1.7 - £2 billion detriment calculation led to multiple party manifesto commitments in the 2017 general election hence to the Tariff Cap Act 2018 which mandated the present tariff cap, and now
- 2021 price increases have led to the destruction of the competitive market and to previously inconceivable Ofgem proposals to further restrict competition.

39. Admittedly, Ofgem was put in a difficult position by the Tariff Cap Act, which required it to impose a price cap (which Ofgem and the CMA had previously advised against) and to carry out an annual review into whether conditions were in place for effective competition. This implicitly assumed that competition was not yet effective. Unfortunately, Ofgem seems to have accepted this assumption, and the CMA analysis, so its annual review has not been robust.

40. Ofgem proposed that three conditions be met for competition to be effective. Condition 1 was that structural changes should facilitate competition. Ofgem found delays in the installation of smart meters and the implementation of faster switching. But whatever the merits of these two programmes and the speed of their implementation, they do not fundamentally bear on the question whether competition is effective.

41. Ofgem's Condition 2 was that the competitive process should be expected to work well in the absence of the price cap. Ofgem had concerns about customer engagement levels and the time taken to implement company efficiency programmes. But these concerns reflect the erroneous analysis of the CMA: customer engagement was not and is not inadequate, and the differential efficiencies of the suppliers, and

whatever time is taken to implement efficiency improvements, do not mean that competition was not and is not effective.

42. Ofgem's Condition 3 was that the competitive process should deliver fair outcomes for consumers. But no economist believes that the competitive process delivers prices that meet some arbitrary ethical definition of fairness. This is not an appropriate criterion for evaluating the effectiveness of competition. Admittedly, Ofgem clarifies that "fair outcomes" here means that customers should not be overcharged through excessive profits or inefficient costs. But (as the Diagram indicates) costs vary in all competitive markets, this does not mean that higher costs are necessarily inefficient. As regards profits, in 2020 Ofgem noted that the aggregate large supplier EBIT margin had fallen annually since 2016, although Ofgem failed to note that this margin was actually negative in 2019. Clearly no excess profits there.

43. To repeat, the Tariff Cap Act put Ofgem in a difficult position by implicitly assuming that retail competition was not effective. But that is no excuse for weak or artificial economic analysis now. The reality is that by conventional competition authority standards, the retail market was effectively competitive when the CMA reported in 2016, and was if anything even more so from 2017 to 2020. The market would be effectively competitive today were it not for the seriously distorting impact of the price cap, at a time of rising wholesale prices. Over the last few months, the cap has essentially eliminated retail competition and destroyed the competitive market.

The impact of the price cap on prices, switching, profits and number of suppliers

44. The CMA was concerned about the extent of price differentials in the market, which it considered (wrongly) reflected weak customer response and ineffective competition. Nonetheless, it recommended against a price cap on Standard Variable Tariffs (SVTs) and instead urged Ofgem to stimulate greater customer engagement and switching. Ofgem, too, had opposed a price cap, and was therefore concerned that a price cap would unduly reduce the spread of prices in the market, which in turn would reduce customer switching and reduce the effectiveness of competition. Ofgem estimated a reduction of switching by 33 to 50 per cent.

45. In the event, price differentials of several hundred pounds initially continued to be available in the market (that is, savings of the lowest price tariffs compared to regulated Standard Variable Tariffs), at times even higher than in previous years, despite the price cap. This suggested that one could have the benefit of effective competition for engaged customers at the same time as protecting vulnerable or disengaged customers by a price cap. What was not to like?

46. Subsequently, it became clear that the initial apparent lack of impact of the price cap had been a fluke. The first couple of years of the cap happened to coincide with a period of generally falling wholesale prices (2019-2020). The cap was set several months in advance, and by the time each six-month price cap came to be applied, the wholesale market had fallen below the level assumed in setting the cap. The cap was therefore not biting in the way that it would have done had wholesale prices remained moreorless stable.

47. Whether the price cap had no effect at all in this early period is debateable: it is even conceivable that some or most SVT prices were higher than they might otherwise have been because the price cap provided a focal point around which not only the larger incumbent suppliers clustered.

48. During 2021, however, wholesale prices started to increase exceptionally rapidly. The price cap again lagged wholesale price changes and became tighter than intended. The cap now had the predictable adverse impacts, indeed much more than previously feared. Price differentials did not simply reduce, they disappeared. Suppliers are now forced to post an SVT price at the price cap level, but they don't want to supply at that price, or attract new customers. A few suppliers still offer fixed tariffs at significantly higher prices than the cap, but customers don't want to buy at those prices.

49. Switching has not simply reduced by 33 – 50 percent, as Ofgem forecast, it has dried up almost completely. No suppliers offer lower prices to switch to. Some commercial switching sites have temporarily closed down, at least one has gone out of business.

50. As fixed tariffs come to an end, customers are not actively switching but gravitating back to SVTs because that price is held artificially low. The previously vibrant fixed tariff market, no longer able to function, must be shrinking steadily.

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

52. From 2004 to 2010 the number of retail suppliers in the domestic energy market was relatively constant at about a dozen (6 large former incumbents and about 6 very small new entrants). From 2010 to the passing of the Tariff Cap Act in July 2018 the number of suppliers rose steadily to around 70. Since then it has been downhill practically all the way. The Energy Shop (3 December 2021) reports 8 domestic suppliers going bust in 2018 (all after the Act), 8 in 2019, 4 in 2020 and no less than 26 in 2021. That is 46 in total. And numerous other suppliers have left the market via a takeover. This is no longer a market to enter, it is a market to get out of.

53. Over these last four years, nearly 5 million customers found themselves transferred to another supplier because their own supplier had gone bust. Their credit balances were protected by Ofgem's policy – but this was at the expense of other customers generally. There are also costs of making good the failures of these suppliers to cover environmental and other costs. Estimates suggest that the total cost to customers will be several billion pounds.

54. It might be argued that some or even most of these costs are not attributable to the price cap. Some suppliers are expected to go bust whatever the conditions. Moreover, it will be said, the extraordinary increase in wholesale energy costs in 2021 could not have been expected and is surely mainly responsible for the problems and costs experienced. And Ofgem has also suggested that there needs to be more severe

tests for licencing suppliers and more checks on their capital availability, operating procedures and hedging policies.

55. There is no doubt that the increase in wholesale energy prices was a critical factor, that it was the combination of the wholesale price increase and the price cap that caused the problems, and that some suppliers were revealed to have inadequate financing or procedures to cope with the total situation.

56. However, there have been comparable increases in wholesale energy costs throughout Europe, but there have not been comparable exits of suppliers or drying up of markets. Similarly, there have been comparable increases in wholesale energy costs in the GB markets for small, medium and large business customers, but again there have not been comparable exits of suppliers or drying up of markets. (Just one SME supplier exit in October 2019 and 2 in November 2021, according to The Energy Shop.) I am not aware that supplier licensing procedures were generally tighter than in GB, either in Europe generally or in the GB business customer markets.

57. In the absence of a price cap, there would of course have been greater price increases over the last year or so. But suppliers would have carried on competing on price, switching would have continued, and most suppliers would not have been forced out of the market. Customers would still have had choices and would have exercised choice. They would not have been locked into their present supplier as they are today. Ofgem would not have needed to prohibit new suppliers from entering the market, nor contemplate such anti-competitive measures as prohibiting price reductions and making suppliers compensate their rivals for taking their customers. The competitive market for domestic customers would not have been destroyed in the way that it has been by the price cap.

PART TWO RESPONSE TO THE BEIS CONSULTATION

58. The Government's retail energy market strategy for the 2020s proposes (in brief) a market to enable net zero, where customers have appropriate protection, energy companies invest in innovative products and services, and consumer choice in a competitive market contributes to a low-cost energy system that gives the right price signals for the update of low-carbon products and services. The Government's present aim is to take account of the lessons from recent months, with a view to refreshing the proposed strategy.

59. The present submission does not argue against this strategy or the present aim. Rather, it focuses on a small number of nonetheless important issues.

Attracting new investment

60. As explained above, the price cap has destroyed the present retail energy market (for domestic customers). It has, in effect, unleashed a bull in a china shop. What's more, the Government has explicitly 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 simply a delusion.

61. The recent wholesale market conditions may be extreme. But the point still holds. Even under more moderate conditions, the price cap means that prices in the market are either controlled by Ofgem or heavily influenced by it. Ofgem's actions are difficult and perhaps impossible to predict, are inevitably influenced by political considerations, and they restrict what it makes sense for a supplier to do. Innovation becomes riskier, if it is worth trying at all. Anticipating and meeting the preferences of customers is less important than anticipating the actions and preferences of the regulator and taking protective action therewith.

62. So, the precondition for achieving any of the aims of the Government's retail energy strategy is to get rid of the price cap as soon as possible and get back to a situation in which prices are set in a competitive market, where suppliers want to enter rather than leave, and where suppliers are rewarded for satisfying their customers and also for innovating in a way that is conducive to moving to net zero.

63. Precisely how this is to be done is for further consideration. My article (footnote 1) suggested some possibilities, including adding a predetermined amount to the price cap at each remaining resetting, so as to reestablish a visibly competitive market by December 2023 at the latest. Some might argue for a more opportunistic approach, or for a longer period of adjustment, giving Ofgem more discretion as to whether and when to relax the cap. But an open-ended commitment lacks credibility: the nationalised industries were required "to break even taking one year with the next": they found that there was never a good year to raise prices, and their continued loss-making over several decades was a major reason for privatisation.

Avoiding a cosy oligopoly

64. Would the market be competitive in the absence of a price cap? This submission has argued that the market was indeed competitive before the price cap was imposed, even though the CMA did not realise this. Unfortunately, the CMA report has given credence to various unfounded concerns. One particular concern seems worth dealing with here. (For further discussion see article in footnote 1 above.)

65. The Secretary of State's 15 December statement warns that "we must not return to the cosy oligopoly of the past". It is true that the same six suppliers supplied all but 1% of the domestic electricity and gas markets from 2004 to 2012. But was this a "cosy oligopoly"?

66. The suppliers were actively competing and trying to increase their efficiency by unifying and modernising their paper-based legacy IT and billing systems. (Albeit the customisation and integration of the new systems proved more problematic and expensive than expected.) They needed to be more efficient because they were actively vying with each other for customers: SSE increased its electricity market share by nearly 50 per cent and nearly doubled its gas market share. Over the same

period British Gas lost over a quarter of its share of the gas market. (Ofgem data portal)

67. During the early 2010s, new entry on a small scale became economic – for example, via ‘supplier in a box’ models. Competition in the wholesale market was also increasing and large-scale wholesale energy providers were now willing to proving low-collateral trading and management of small suppliers’ trading positions. Government and Ofgem took additional steps to facilitate new entry, including by exempting entrants from significant social and environmental costs. The number of entrants increased four-fold, from six at end-2010 with a combined market share of about 1%, to 23 in early 2015 with a combined market share of about 10%.

68. The six incumbents might have seemed to the CMA to have enjoyed a cosy oligopoly since the early 2000s, with the apparently lower cost new entrants not making much progress. But as noted the market was never cosy, and by late 2019 the entrants’ market share had tripled to 30 per cent. A year later two of the former Big Six had been taken over, and as of mid-2021 the entrants’ aggregate market share had reached about 45 per cent.

69. Certainly, one would not want to encourage a new cosy oligopoly. But maintaining the price cap would do precisely that. At present the cap has frozen the market shares of the remaining companies. Competition no longer exists: there is no scope for it. Suppliers are neither able nor willing to compete for new customers. Customers have no interest in moving to another supplier, who can offer nothing better than their present one. Things might ease if and when the price cap is relaxed, but Ofgem has already restricted new entry and is now considering discouraging any emergent competition by restricting price cutting and taxing the attraction of new customers. Thus, a precondition for avoiding a cosy oligopoly is the early removal of the price cap, and the avoidance of further restrictive regulation.

The ‘loyalty penalty’

70. The Government’s July 2021 strategy included a consultation on opt-in and opt-out switching “which sets out long-term plans to tackle the causes of the so called ‘loyalty penalty’, where energy companies place longstanding customers on the most expensive tariffs”. (Update statement by Minister of State, 23 July 2021)

71. However, economic analysis suggests that concern about such a ‘loyalty penalty’ is misplaced and attempts to prevent it will increase prices to customers generally. Moreover, evidence does not suggest customer opposition to any loyalty penalty.

72. The CMA was concerned that many customers appeared to be loyal to their existing suppliers, were reluctant to engage in the market and switch supplier, and consequently missed out on the lower prices available to more engaged customers.

73. As explained above, many supposedly ‘loyal’ customers had and have good reason to stick with their present supplier, despite apparently lower priced offers available elsewhere. The other products offered at lower price may be less attractive to the customer, the quality of the supplier may not be as high, and importantly, in

light of recent events, the new supplier may be more risky – at least less well-known and trusted – than the present supplier. So there is no basis for assuming that customers generally are acting irrationally.

74. Offering different prices to different sets of actual or potential customers is not necessarily evidence of monopolistic exploitation. As Baumol and others have explained (see footnote 1 article), it may be a necessary strategy to survive in a particularly competitive market: competition may force suppliers to differentiate their prices. In particular, suppliers may need to offer different prices to 'loyal' and new customers in order to spread the overhead costs of running a supply business over more customers and thereby reduce the prices they can offer. To prohibit or discourage such a strategy will remove the lower prices to new customers without reducing the higher prices to existing 'loyal' customers. This was indeed what happened when Ofgem prevented suppliers from offering lower prices out of their previous regional areas than they charged within these areas. Competition was restricted, and prices were higher than they otherwise would have been. The aim of reducing or removing the 'loyalty penalty' may be well-intentioned, but it is misplaced and will be against the interest of customers generally.

75. There is also relevant evidence from experience in the UK market as to how far such a policy is preferred by customers and is commercially viable. Some suppliers have actively advocated and implemented a policy of avoiding or minimising a loyalty penalty. Some such suppliers have offered a single variable tariff, others a single fixed tariff, and yet others a set of fixed and variable tariffs that do not vary by any considerable amount. These suppliers explain that they do not wish to treat their different customers differently, and they think customers will prefer such a relatively simple and "fair" tariff arrangement.

76. Such distinctive approaches are to be welcomed. They seem to address a strongly felt concern amongst some customers – or at least amongst certain customer groups and/or political pressure groups. A virtue of the competitive market (when it is functioning) is that suppliers are able and willing to offer such tariffs and seek to attract customer support.

77. So what has been the experience? I calculate that from January 2018 to November 2020, the number of suppliers offering either a single tariff or several tariffs with a small (under £30) tariff differential fell from 13 to 9. The number of suppliers offering only a single tariff fell from 12 to 2.

78. As of November 2020, the suppliers advocating a uniform or near-uniform tariff seemed to account for about one eighth (12.5 per cent) of the residential market. This is a respectable proportion and suggests that these suppliers were meeting a felt need of their customers.

79. But seven eighths of all customers were not with suppliers offering such tariffs. Some of them wanted a low-priced tariff, regardless of what higher prices their supplier offered to other customers. Others of them were satisfied with their existing tariff, again regardless of what lower prices their supplier offered on other tariffs or to other customers. In other words, seven eighths of all energy customers did not seem concerned about a hypothetical 'loyalty penalty'.

80. What has been the subsequent experience of the suppliers that sought to avoid a loyalty penalty? So Energy was an early and apparently successful proponent, and it grew to be a Medium supplier, but eventually concluded that a single tariff was not viable. It introduced a moderate tariff differential and in August 2021 was taken over by ESB, which does not seem to share the single tariff philosophy. Other proponents included Igloo Energy, Green and Utility Point, all of whom went bust in September 2021. The largest and most explicit advocate of the single tariff, Bulb, went bust in November 2021, and is presently sustained only by virtue of quasi-nationalisation. Thus, those suppliers that have argued against a loyalty penalty, and advocated and implemented a uniform or near-uniform tariff, have generally not survived in the competitive market, albeit a market severely distorted by the price cap.

81. One significant and successful supplier does still subscribe to the philosophy of small tariff differentials, namely Octopus Energy. But that supplier may also be the most efficient and lowest cost supplier in the market. For most other suppliers, committing to avoid a loyalty penalty does not seem to be a commercially viable strategy in what used to be a very competitive retail market. And for the Government or Ofgem to prohibit a 'loyalty penalty' would be to restrict competition at the expense of some customers, and to impose a particular commercial strategy that would favour some suppliers at the expense of others.

Opt-in and Opt-out switching

82. The BEIS July consultation included plans to use opt-in switching and trial opt-out switching, both of which aimed to "tackle the causes of the so-called 'loyalty penalty'". As regards opt-out switching, there would be trials of a new system in 2024 "in which consumers on costly tariffs would be automatically switched to cheaper ones unless they opt out". (Letter from Minister of State, 23 July 2021) There were also plans to use similar methods to "take consumers on the journey to a net zero energy system". (BEIS Consultation p 5)

83. The argument in this submission suggests that this policy needs to be modified and limited (though not necessarily completely abandoned). As explained above, there is not a competition problem needing to be addressed (except that the price cap has destroyed the market). Customers were not guilty of "weak customer response" and did not need to be prompted to engage further. The so-called "loyalty penalty" is a characteristic of many fully competitive markets. It would be a mistake to seek to eliminate it.

84. Furthermore, one of the increasingly significant reasons for staying with a known albeit higher priced supplier is the belief – now shown to be well-founded - that such suppliers are less risky than unknown new ones. Actively encouraging customers to switch – via either opt-in or opt-out methods – could expose them to more risk of their supplier going bust and them being switched to yet another supplier, very possibly at a higher price.

85. So any opt-in switching policy, and even more so any opt-out switching policy, has to recognise that price – or for that matter some environmental

characteristic – is not the only relevant one. Many factors influence a customer's satisfaction or lack of it with a particular supplier. It is therefore not straightforward to determine which if any other offer is preferable to the customer's present choice. Urging customers to change their previous decisions is a more serious and difficult matter than previous policy proposals assumed. To override or even seek to sway a customer's own judgement therefore needs more consideration, and more evidence that customers will actually be better off as a result, than has hitherto been apparent.

86. Opt-in and opt-out switching policies are unnecessary as a means of attempting to make the market more competitive. Are they justifiable as a means of improving the situation of particular vulnerable customers? The risks are rather significant, and would seem to require more personalised and continued monitoring both of customers and suppliers than previous trials have been able to provide. Whether the risks that such policies impose on customers are justifiable for purposes of net zero requires further consideration. But one thing seems clear: the risks to suppliers from a continuation of the price cap will deter their participation in such schemes.

PART THREE RESPONSE TO TWO OFGEM CONSULTATIONS

Financial risk management

87. In 2020 and 2021 Ofgem introduced various new requirements on suppliers aimed at improving standards of financial resilience and consumer protection. Following the recent increase in energy prices it proposes to go further, including via more severe milestone assessments and requirements to notify Ofgem about significant commercial developments and personnel changes.

88. The present response questions the present emphasis on more regulation, and also the lack of recognition of the role of the price cap.

89. In any market, financial risk arrangements are determined by the interaction of three main parties: the suppliers, the customers and the regulator(s). Suppliers have to choose (e.g.) the level and composition of capital financing and the extent and nature of hedging. More capital and hedging enable them to offer a more secure product, but they are also more costly hence will need to be price more highly. So they have to strike a balance. And typically different suppliers will strike different balances, aiming at different types of customers perhaps.

90. Similarly, customers implicitly make what judgement they can of the financial soundness of the suppliers with which they deal. This will depend on how significant this factor seems to be – for example, whether it is a one-off purchase or a lifetime commitment. Some customers, for example on low incomes, may feel more vulnerable than others. And they may well make that judgement only implicitly, by looking for example at how long that supplier has been operating in the market, whether it has survived many winters.

91. Regulation is a means of tipping the balance in one direction or other, typically of requiring more severe and therefore more costly arrangements. This

increases prices to customers somewhat but is nonetheless considered (by the regulator) to be worthwhile.

92. When the retail energy markets first opened, there was relatively little regulation of financial risk arrangements. At times, there has been criticism of the lack of regulation. In recent years and months the extent of regulation by Ofgem has grown significantly. So this consultation is responding, in part, to popular demand and changing circumstances. But it has also been influenced by policy considerations that themselves are changing.

93. The present Ofgem consultation sets out the case for more severe Ofgem constraints on financial risk management. It argues that customers and suppliers themselves will benefit and that customers will in fact benefit from lower bills (as a result of lower mutualised costs of supplier failure) rather than suffer from higher bills (as a result of more costly obligations and regulation). And it is claimed that consumers should feel more confident about switching in the market.

94. The consultation makes basically no reference to the role of customers in monitoring the financial risk arrangements that suppliers adopt. The view is that it is for the regulator, not suppliers or customers, to decide what financial risk arrangements should be adopted. Two problems with this perspective will be noted here.

Regulatory limitations

95. First, regulators are not very good at deciding on financial risk arrangements. They do not have the first-hand day-to-day knowledge of markets, financial instruments and customer preferences that suppliers have. They tend to respond unduly to media and political pressures. They feel the need to Do Something. They naturally err on the side of caution – that is, imposing more severe restrictions rather than less severe - because that minimises the political and media risk. They respond sporadically and with dramatic changes, when the political focus is upon them, rather than adjusting in small steps to changing market conditions, and the direction of movement is almost always towards more regulatory intervention, with no pressure to reduce regulation when circumstances change. So the industry is left with costly but out-dated and unnecessary restrictions.

96. This is not a criticism of Ofgem specifically, it is what decades of theoretical and empirical economic research has established about regulatory behaviour generally. The reason for making the point here is to caution against unduly increasing regulatory requirements at this time, and against making Ofgem the central or only determinant of financial risk management arrangements. It is important to recognise that suppliers and customers have a role too.

97. As an alternative to Ofgem proposing and implementing more scrutiny and specification of supplier financial risk management, a better approach in the long run might well be to require suppliers to hold a minimum amount of risk capital. Whoever provides that risk capital (capital market or parent company) will have a strong

incentive to scrutinise the supplier's financial risk management and will almost certainly do it better than Ofgem.

98. In recent years, the role of customers appears to have been deliberately downplayed. The overriding aim seems to have been to increase competition by increasing switching, to which end any risks associated with new entrant suppliers are either eliminated (by tougher financial regulation) or downplayed (by never mentioning such risks to customers) or mitigated (by assuring customers of such suppliers that they won't suffer personally, because other customers will be made to foot the bill). Here too, as just noted, a stated aim of the proposed increased regulation is that "consumers should feel more confident about switching" (p. 8).

99. It is argued above that this concern to increase competition by increasing switching is misplaced. Of course, switching should be possible and indeed facilitated. But the retail market is not in the uncompetitive state that the CMA portrayed, and there is no particular need to take regulatory measures to increase switching. Indeed, there is every advantage in levelling with customers, providing them with relevant information, and letting them decide – as they do in most competitive markets - which suppliers to trust.

100. To that end, Ofgem might wish to consider providing information about the financial risk management states and processes of the different suppliers, rather than (or perhaps as well as) specifying and enforcing particular kinds of states and processes. No doubt most customers would not be interested in such detail, and would not have the ability to assess it. But various consumer organisations would have that interest and ability, and could provide a simple grading system to separate the sheep from the goats.

Changing market conditions

101. The second problem with the consultation perspective is that it makes almost no reference to changing market conditions. The analysis and recommendations are presented as timeless: equally as valid ten or twenty years ago, or ten or twenty years in the future, as today. There is just one single suggestion, in an unclear and grammatically-challenged sentence, that the risk of something bad happening "is heightened during a time when a large number of suppliers are facing severe financial challenges" (p. 7).

102. Surely the level and nature of such risks depend critically upon the market conditions in any market, and also upon a variety of technical, social and political developments?

103. There is no recognition in the Ofgem consultation that competition is a process of discovering (inter alia) what kinds of hedging arrangements and credit controls are most economic in each set of circumstances. Ofgem can impose stricter controls on suppliers and limit new entry, but that presumes that Ofgem knows better what kinds of internal financial arrangements are most economic than the suppliers themselves do.

104. In practice, financial risk management needs constant reassessment and readjustment, at times tightening and at other times relaxing, and at yet other times modifying its nature or emphasis. That continual adjustment is what regulation is not good at, and why the central role of suppliers and customers needs to be recognised.

105. The most glaring example of the failure to recognise changing conditions is the astonishing failure to make any reference to the price cap. There is no recognition that at the present time, "when a large number of suppliers are facing severe financial challenges", these severe financial challenges have in significant part been created, and at the very least been substantially exacerbated, by the price cap. Suppliers are being forced to price significantly below cost, with no control over their present or prospective future prices or customer numbers.

106. In other words, the existence of the price cap, and Ofgem's setting of it, have been a major contributor to the present financial problems and the associated costs, risks and other harms to suppliers and customers. This has at least two important implications.

- First, it is within the power of Ofgem and the Government significantly to reduce those costs, risks and harms by relaxing and then removing and not renewing the price cap. That will have greater and more significant benefit than any modifications to the financial risk management regulations.
- Second, any modification to the financial risk management requirements needs to recognise that recent events and present conditions are not typical of a competitive market. They reflect a competitive market that has not been allowed to respond to underlying changes in market conditions, and in the process has temporarily, at least, been destroyed by the price cap. Requiring suppliers to adopt financial risk arrangements based on ability to withstand such a price cap would increase costs and restrict competition significantly and unnecessarily, to the disadvantage of customers - if indeed any suppliers were willing to enter and operate in such a market.

Ofgem's potential short-term interventions

107. Ofgem has issued a consultation on potential short-term interventions to address risks to consumers from market volatility. The consultation rightly explains the difficult situation in which suppliers presently find themselves as a result of volatile prices. What the consultation does not do is highlight, or in many places even acknowledge, that the difficulty of the situation has arguably been created, and certainly greatly exacerbated, by the price cap. If suppliers could adjust their prices to the volatile and increased costs, they would not be in the difficulties described. But the price cap prevents them from doing so.

108. The potential Ofgem interventions are basically to try to stop change. If everybody stays where they are for a few months, things will be better than if they keep moving around. Although Ofgem indicates its reluctance to adopt such measures, Ofgem takes them seriously enough to consult on them is a worrying

indication of a lack of appreciation of the fundamental nature of the problem and of the obvious solution.

109. The first suggested intervention is requiring suppliers to make all new tariffs available to existing customers. The stated aim is to reduce the incentive of suppliers to reduce their prices to attract new customers, with a view to 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 once it is realised that the present high costs and risks of customer churn are caused by the price cap, then eliminating the price cap is the more obvious and sensible solution.

110. The third suggested Ofgem intervention would "require all suppliers acquiring a domestic customer to pay a 'Market Stabilisation Charge' to the losing supplier". Again, this would adversely affect competition, so customers would suffer. It is directly opposite to Ofgem's previous and correct policy of encouraging companies to compete. Surely the "problem" that it seeks to address has largely or entirely been caused by the price cap (and/or by the unavailability of exit fees on SVTs, as now discussed). Both of these two interventions would be blatantly anti-competitive.

111. In contrast, the second suggested intervention - to allow 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. There may be some customers or conditions for which an exit fee is inappropriate, but not as a generality. Now is an appropriate time to relax that policy permanently, and not just faff around with it from February to September 2022.

112. In all three cases, the proposal that these 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. It also suggests a failure to acknowledge that it is the price cap, rather than the unprecedented increases in wholesale prices, that is causing such havoc and distortion in the market.

113. Part of the solution may lie in the revision of the price cap methodology. But more important is ending the cap. The overriding aims should be to begin significantly relaxing the price cap in April 2022, to ensure that it is no longer constraining the competitive market by late 2023, and to begin to make the case for not attempting to renew it after December 2023.

Concluding remark

114. During the 1990s and 2000s, the UK was the leader in opening retail energy markets to competition, and widely acclaimed as the model to follow. Throughout, not least in 2016 and indeed in 2018, it was arguably the most vibrant and competitive domestic/residential retail energy market in the world. Since then, the CMA, Government and Ofgem have between them wrecked this market. Suppliers that have not yet been forced out are required to provide energy at a regulated price, but the

market no longer functions. For years and perhaps centuries to come, this destruction will be a standard textbook example of the unintended adverse consequences of a price cap.

115. The challenge now is to revive the competitive market before yet more suppliers are forced out. 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, innovative and customer-oriented competitive market seems remote.