Discovery, Doubt, Delusion, Ducking, Destruction, Desperation, Diagnosis, Discipline, Disregarding, Direction and Decease?

Regulation and the evolution of the GB competitive retail energy market

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Discovery: Ofgem's initial approach

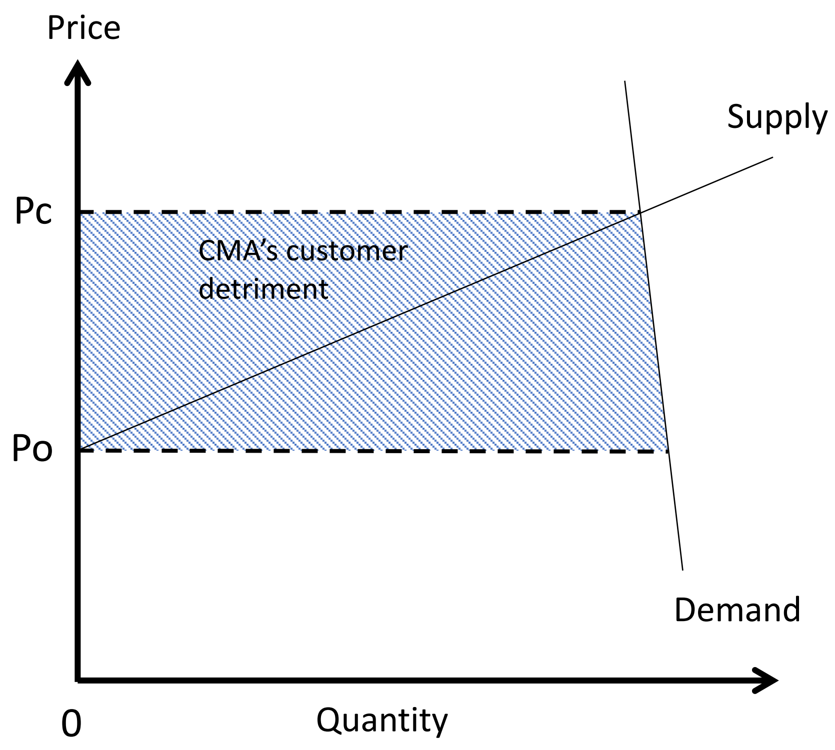
- 1997-2007: retail competition is going to work – and is working
  - Initial transitional price caps phased out by 2002
  - Existing suppliers competing out of area & entry of new suppliers
  - Annual switching up from 16% in 2005 to 20% in 2008
- Not just lower prices - competition as a rivalrous discovery process
- What product/price combinations do different customers prefer?
  - E.g. Higher price but sponsorship of charities or football clubs
  - E.g. Lower price but webchat instead of live customer service agents?
- Also (later): how much uncertainty and risk do customers want?
  - Fixed prices or variable prices?
  - Willing to provide customer capital to reduce costs and prices?
  - Known low-risk high-price suppliers or unknown higher-risk lower-price entrants?
  - Different customers want different price/product/risk combinations – hence different suppliers
- This is the competitive market discovery process in action

Doubt: Ofgem’s later approach

- 2008, 2012 Some wholesale & retail price increases
- Ofgem concern (and political pressure from Labour Govt/Miliband)
  - Many customers not switching to lower prices available
- Behavioural perspective: weak customer response
  - Many customers don’t know what they are doing, must guide them
- 2009 Non-discrimination condition to protect weak customers
- 2011 Maximum four simple tariffs to assist weak customers
- 2014 Ofgem reference to CMA: Is competition working?
- CMA found both Ofgem policies had reduced competition
  - They had removed low tariffs
  - And halved switching from 20% in 2008 to 10% by 2013
- 2016 Ofgem ceased both policies
  - Led to more vigorous competition, & switching rose back up to 20% by 2018

Delusion: the CMA’s £2bn customer detriment

- Economic analysis says competitive price is Pc
  - Intersection of Supply and Demand curve
  - Customer detriment if price above Pc
- Competition Authority Guidelines agree
- Competition Commission (cement 2014) agreed
- But CMA 2016 said competitive price was Po
  - The lowest point on the Supply curve
- And calculated customer detriment of £2bn (£70/cust)
- Concern about this led directly to the price cap
  - Despite CMA advice against a cap
- But there was no such customer detriment
  - Maybe a tenth of that?
- CMA analysis & cap the biggest mistake in the history of GB competition policy?



Ducking: Is competition effective?

- Tariff Cap Act requires Ofgem to report annually whether competition is effective. Ofgem's 3 tests are ad hoc and unconvincing
  - Smart metering in place? No. *Arguably creative but irrelevant*
  - Would competition work well in absence of cap? Can't be sure
    - Not enough switching – *CMA/Ofgem obsession, at 20% as high as anywhere in the world*
    - Large supplier efficiency programmes will take time – *Obviously, but irrelevant*
    - Covid has placed a financial strain – *Yes but irrelevant*
  - Fair outcomes? Not sure, a risk to remove cap
    - Not excessive profits? *No answer, just agonising on uncertain how price differentials will evolve*
    - Good quality of service? No, cheaper deals might be worse *To be expected in a competitive market*
    - Access to a range of different tariffs? No answer *An evident unwillingness to say Yes*
- Ofgem ignores conventional excess profit test of competition
  - SCL rough estimate ave £170m/yr 2007-14 or about £6/customer/year on c £1000 bill
  - Market more competitive 2015-19, largely negative profits don't suggest market power
- No attempt to assess impact of cap, or whether market more competitive without it
- Conclusion: Ofgem has evidently taken a political approach not an economic one

Destruction: the effect of the price cap

- Price cap initially (2019-20) seemed benign – only due to falling wholesale price
  - Outturn wholesale cost lower than estimated cost when price cap set
  - Even so, 15 suppliers went bust 2018/9 - 2019/20 compared to 2 in 2016/7 – 2017/18
- When wholesale price started rising (late 2021), cap impossibly severe (see later)
- 24 domestic suppliers forced out of market since August 2021
  - affecting 4 m customers & significant costs to all households (Ofgem)
- Immediate destruction of competitive market – no longer a market price
  - Low regulated Standard Variable Tariff price at which no suppliers wanted to sell & a few much higher fixed tariff prices at which no customers wanted to buy
  - Some suppliers wanted to lose customers because price cap made them unattractive
  - Switching sites closed
- Problem is ongoing
  - This week: 12 SVTs at £1970 cap, 3 suppliers offering fixed tariffs at £2700, £3350, £4120

Desperation: Inaction Plan - Stop Competition

- 19 Nov 2021 Ofgem consultation on wholesale cost volatility
  - Discourage suppliers from cutting prices to attract new customers
  - Make suppliers gaining customers pay an exit fee to losing supplier
  - Consider charging customers leaving Standard Variable Tariffs
  - Prohibit entry of new suppliers, and extend entry processing time to one year
- But wholesale cost volatility alone would not have necessitated such measures
- The cause of the problem was the price cap, which caused massive problems
  - Set too low (accepted mistaken CMA analysis, & Ofgem held to have acted unlawfully to deliver this)
  - Required hedging was costly and longer than expected
  - The consequent volume risk was serious and much higher than expected
  - The lack of a recovery mechanism (as per network price controls) meant losses & higher risk
- With wholesale cost volatility, customers moving between suppliers was inconsistent with the costly hedging that the price cap necessitated

Diagnosis: reason for suppliers going bust

- The price cap in effect turned variable tariffs into fixed tariffs needing longer hedges (12-14 months) which were more risky and more costly
- This forced many suppliers to change their business model (e.g. Bulb, Avro)
    - "So we had a hedging policy of procuring energy for our customers six months in advance, but the price cap methodology … required us to hedge out for 12 to 14 months in order to match our wholesale procurement with the price cap, but we just did not have access to those seven to 14-month markets through our trading counterparties." (H Wood, Bulb, BEIS Committee, 19 Apr 2022, Q 276)
    - "we followed a hedging strategy where we tried to buy little and often, looking at opportunities in the market. Of course, you can always go out and hedge gas and power for a long period of time, whether it is 12 months or whatever you are looking to do, but if that price collapses, you do get a margin call on that, which is obviously very large and very quick …. we were concerned that Nord Stream 2 was going to come online towards the latter part of 2021 and collapse the price, and we would be faced with a massive margin call that we would not have been able to meet." (J Brown, Avro, BEIS Committee, 19 Apr 2022, Q 345-6)
- Without price cap, many smaller suppliers could have survived, with prices changed/increased more frequently
    - Note there were not such extensive supplier failures in other markets with similar wholesale price increases & volatility but no price caps (e.g. UK small business market & other EU markets)
- Then up to customers to decide which products & suppliers they preferred

Discipline: more Ofgem intervention

- 14 April 2022 Update “recap on the need for intervention”
  - “This [previous policy] has allowed suppliers with insufficient capital and poor business models to enter the market and grow unsustainably. … more specific licence provisions and a greater level of oversight are required”
- 15 Dec 2021 Ofgem Action Plan to boost financial resilience (Do More Regulation)
  - Stress testing suppliers, management control of financial risks & over material assets
  - More Ofgem ability to intervene at milestone assessments, changes in personnel & trade sales, stronger financial risk controls, fit & proper person testing in granting licenses
  - Financial resilience – more reserves to protect customer credit balances & renewables obligation payments
- Agreed that previous Ofgem policy had some disadvantages
  - Lax Ofgem/BEIS rules for Renewable Obligation payments a serious weakness (c £200m cost)
  - Ofgem’s customer safety net favoured risk-taking suppliers at expense of other customers
- Some scope for more checking of supplier finances & ability to pay their bills
- Ofgem could have provided more information to the market
  - Information about supplier risks for customers, advisors, comparison websites to assess

Disregarding: overlooked aspects of competition

- But Ofgem policy on supplier entry had advantages
  - More entry, more product variety, better discovery of customer preferences
  - Lower prices because tighter controls (finance/asset base/hedging) are more costly
  - Suppliers could explore whether less costly capital & hedging approaches were viable for some customers
- Some customers prefer known established suppliers despite higher price
- Suggests that customers who didn't switch to unknown lower price suppliers were not weak – they *did* know what they were doing – but CMA/Ofgem overruled their preferences
- Now Ofgem's stricter rules may be overruling preferences of those active customers who are willing to accept risks
- Ofgem uniform tougher standards means higher costs & prices, & limits competitive discovery process

Direction - the journey to net zero

- CMA 2016 Aim was a competitive market, price cap a means to that end
- July 2021 BEIS/Ofgem envisaged working with the competitive market
    - Behavioural perspective again
    - “to take consumers on the journey to a net-zero energy system”
    - “Potentially more action (e.g. through opt-out switches) to nudge consumers and suppliers towards more competitive and/or low carbon products”
- 20 Sept 2021 While maintaining the price cap
    - “Central to any next steps is our clear and agreed position that the Energy Price Cap will remain in place” (BEIS/Ofgem statement)
- 15 Dec 2021 Govt to review Energy Retail Market Strategy
    - Still committed to seeking to extend the price cap. “The energy price cap has shielded millions of customers from price volatility in wholesale markets.”
- But present Price Cap Act does not provide for shielding from price volatility
- Doing so means avoiding/suppressing the competitive market?

Decease?

- Govt/Ofgem committed in principle to competitive markets. But not in practice
- The price cap has destroyed the competitive retail market
  - No longer a market price
  - Little scope for customer preferences, which are increasingly overuled
  - Mass supplier exit: extreme risk & negative profits - Who would invest in supply now?
- Govt/regulatory preferences are replacing customer preferences
- Competition is a process for discovering & providing what customers want, not what governments & regulators want
- So why bother with the competitive market?
  - Wouldn’t it be simpler just to tell suppliers what products to provide?
- GB pioneered the competitive retail energy market
  - Arguably had the most competitive retail market in the world, though not recognised
- But does the competitive retail energy market now have any future in GB?