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15 August 2014

Dear Will

This is in response to the CMA's invitation to submit evidence in connection with its present investigation of the domestic retail energy sector, and in the light of its recent *Statement of Issues* of 24 July 2014.

Please find attached a paper entitled "Promoting or restricting competition? Regulation of the UK retail residential energy market since 2008". This has been written with a view to publication in a professional economic journal, but also with an eye to some of the issues that arise in the CMA investigation.

Briefly, the main aim of the paper is to understand and appraise Ofgem's change of retail regulation policy since 2008. It seeks to draw together a number of the critiques that I have written in recent years, and also to provide references to the work of others that bear on this point.

I hope this will be of assistance to the CMA in its important investigation. I would be happy to provide copies of the papers referenced therein, or to discuss further if that would be helpful.

I confirm that there is no confidential information in the paper, and I am content for it to be published on the CMA website.

Sincerely

Stephen Littlechild

Promoting or restricting competition?
Regulation of the UK retail residential energy market since 2008

Stephen Littlechild[*]

15 August 2014

1. Introduction

By about 1998, the whole of the UK electricity and natural gas sector was opened to retail competition, including to residential customers. This was despite considerable scepticism. An Electricity Area Board chairman had told me "It will never happen". Leading US energy economists warned me "It won't catch on". But it did happen and did catch on, in most developed countries around the world, including the EU. Many of these other jurisdictions have followed the lead of UK regulation on this issue.

In the decade after 1998, the energy regulator Ofgem (Office of Gas and Electricity Markets) addressed a variety of initial concerns and teething problems in the residential market, but reported positively on the evolution of competition. The UK was widely held to have the most competitive retail market in the world. On 16 January 2008, responding to Government and public concerns about price increases, Ofgem issued a press release headed "Market is sound – Ofgem assures Chancellor".

Yet one month later, on 21 February 2008, Ofgem issued another press release headed "Ofgem launches probe into energy supply markets". This was "to address mounting concern among customers that could undermine competition". The Probe Initial Findings in October 2008 expressed numerous concerns about the development of competition. Ofgem proposed and then implemented a pair of licence conditions prohibiting suppliers from discriminating by region or by payment method. This was the first of a series of increasingly restrictive obligations on retail energy suppliers to the residential market. In 2011, as part of its new Simpler, Clearer, Fairer policy, Ofgem proposed a uniform standard tariff where Ofgem would set a common monthly standing (customer) charge and the suppliers would compete only on the unit charge. Ofgem later withdrew this proposal but instead, in 2012-13, restricted each supplier to a maximum of four different residential tariffs per fuel, and prohibited various forms of discounts and tariff variants. Ofgem has also imposed a parallel series of measures on suppliers to small business customers [1]

Since 2012, apparently stimulated by Ofgem's willingness to consider radical interventions in the market, many other parties including present and former prime ministers and energy ministers have suggested a variety of different but often drastic policies, which have received active public discussion. These included proposals to oblige suppliers to put customers on the

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[*] Emeritus Professor, University of Birmingham; Fellow, Judge Business School, University of Cambridge; and former Director General of Electricity Supply (1989-98). This draws on my earlier presentation "Simple tariffs or simply anti-competitive? Ofgem's Retail Market Review and associated developments", Beesley Lecture, IEA-Marketforce, London, 17 October 2013. I am grateful to Michael Pollitt and other colleagues for helpful comments and suggestions, but none is responsible for the views expressed herein.

[1] These measures include restrictions on "roll-over" terms at the end of contracts. For reasons of space, the present paper discusses only regulatory policy related to residential (domestic) customers.

best tariff, to limit each supplier to a single nationally uniform unit charge, to impose a windfall tax on energy suppliers, and to freeze energy tariffs until after the next election. Ofgem, the Government and the Opposition all describe their policies in essentially the same words: "the biggest overhaul of our energy market since privatisation".

Public concern was not assuaged. In late 2013 the Government announced that Ofgem and the competition authorities would carry out a competition assessment of the retail market. In March 2014 this assessment identified a number of features of the market that may have an adverse effect on competition. In June 2014 Ofgem referred the residential retail energy sector for a market investigation by the new Competition and Markets Authority (CMA).

Such a dramatic reversal of regulatory policy, and the emerging concerns about the retail market, invite some explanation and appraisal.

- What effects has Ofgem's change in policy had and what might it have in future?
- Do other recent policy proposals have any merit?
- Why did Ofgem change its policy?
- Should regulators of competitive retail markets in other jurisdictions and indeed in other sectors follow suit, or avoid such policies?

Ofgem and the Government naturally defend the new direction of policy. Regulators in some other sectors are inclined to move in a similar direction.[2] In contrast, it has been argued that "a once showcase example of residential electricity market competition is being undermined by increasingly misguided politically motivated interventions in the way the market operates".[3]

The present paper attempts to answer the questions posed above.

- Section 2 describes the early evolution of Ofgem's policy, the arguments for and against its non-discrimination rules, and the accumulating empirical evidence on their effects to date, including on prices, customer switching rates, retail profit margins, the conjectured cost to customers and new entry.
- Section 3 analyses the subsequent evolution of Ofgem's policy and its likely consequences.
- Section 4 describes and comments on other recent policy proposals.
- Section 5 analyses the early publications associated with Ofgem's reference of the market to the CMA.
- Section 6 asks what caused Ofgem's change of policy, and examines three possible explanatory factors: movements in residential energy costs and prices, changes in Government policy and Ofgem's statutory duties, and changes in the role and influence of economists at Ofgem.
- Section 7 concludes.

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[2] E.g. "We will continue to develop our thinking on whether to intervene in this market, and what interventions would be most effective in improving competition in the interests of consumers….. However, if we consider that such measures would be likely only to prompt a marginal number of consumers to become more engaged and/or active, we will consider whether other interventions are necessary to improve outcomes for consumers overall." Financial Conduct Authority, *Cash savings market study: interim report*, MS14/2, July 2014, p 7.

[3] Pollitt, M G and A B Haney, "Dismantling a Competitive Retail Electricity Market: Residential Market Reforms in Great Britain", *Electricity Journal*, 27 (1), January 2014: 66-73.

2. The Evolution of Ofgem's Regulatory Policy

2.1 Ofgem's policy until 2008

The possibility of creating retail competition in the electricity market, via competing private retailers with access to local distribution networks, was first proposed some 30 years ago.[4] Five years later, the UK Government endorsed the concept of retail competition for large industrial users in its proposal for privatising the electricity industry.[5] In the event, the electricity market was opened to all retail customers, including domestic (residential or household) customers, over the eight years 1990-1998. [6] By the end of that period, the natural gas market too was wholly open to retail competition.

When the retail energy market for UK domestic (residential/household) customers and small business customers was opened in 1998, the previous 'cost pass-through' price controls were removed but certain transitional price caps were put in place. In 2000 Ofgem removed the price caps from the small business market but retained them for most residential customers.

The structure of the energy market continued to evolve over the years following privatisation, particularly around the time of full market opening.[7] By 2002 the incumbent gas supplier British Gas (aka Centrica) had acquired generation capacity and become the largest residential electricity supplier, with 22% of the market. Between 1998 and 2002 the 14 incumbent electricity suppliers consolidated into five vertically integrated suppliers, all competing in the retail gas market too, where in aggregate they had taken nearly 40% of the market from British Gas. These six suppliers, often referred to as the Big 6, accounted for 99 per cent of residential customers. There were occasional new entrants into the residential supply market, many of them transient, and never supplying more than about 1 per cent of the market in aggregate.

In 2002 Ofgem abolished the price caps because competition was now effective.[8] Ofgem explained that competition could deliver more benefits for customers than regulation. And regulation could jeopardise competition, particularly regulation focused on prices to particular customer groups.[9] Ofgem proposed to focus instead on use of competition and consumer law

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[4] Beesley, M and S C Littlechild, "Privatisation and Monopoly Power", unpublished paper for H M Treasury, November 1983.

[5] *Privatising Electricity*, White Paper Cmnd 322, London, 25 February 1988. The present paper uses the term UK because it is more familiar internationally. Strictly speaking the discussion refers to events in Great Britain (that is, England, Wales and Scotland, but not Northern Ireland).

[6] For an account of the process of creating retail competition in the UK energy sector, see Stephen Littlechild, "The creation of a market for retail electricity supply", in Eric Brouseau and Jean-Michel Glachant (eds), *The Manufacturing of Markets*, Cambridge University Press, 2014.

[7] Ofgem, *Domestic Retail Market Report – March 2006*, Ref 110/06, 5 July 2006. For further background on the sector, see Ofgem, *Energy Market Investigation: Initial submission to the Competition and Markets Authority*, 21 July 2014; also Ofgem, *Energy Supply Probe - Initial Findings Report, 140/08, 6 October 2008*, section 2.

[8] Ofgem, *Review of domestic gas and electricity competition and supply price regulation: Conclusions and final proposals*, February 2002. Ofgem's Chief Executive was quoted as saying "The evidence is overwhelming that competition is effective across all social groups and all methods of payment". BBC News 15 February 2002.

[9] "In early 2002 it was already clear that competition was bringing substantial benefits to customers, including vulnerable customer groups. These benefits already included substantial price competition, and it was evident that suppliers were investing and innovating as a result of competitive pressure. These are benefits Ofgem judges could not be achieved through direct regulatory intervention. Ofgem's analysis in early 2002 was that, on the one hand, competition would provide greater benefits, for all customer groups, than price regulation; and on the other, that on-going price controls posed serious risks of braking or throwing into reverse the development of competition. These risks were judged to be the more serious if regulation were to be more tightly focused on prices paid by particular customer groups." Ofgem, *Domestic gas and electricity supply competition*, 7 June 2003, para 3.6.

powers.[10] A year later it outlined "Ofgem's substantial programme of work to remove continuing obstacles to competition (for example, reviewing the transfer process, tackling misselling, reforming rules for objecting to switches, improving competition for dynamically teleswitched customers, as well as enforcing competition law)".[11] It also sought to improve customer information and billing standards. [12] But there were essentially no restrictions on what suppliers could offer or charge.

From 2002 to 2007, Ofgem issued further retail market reports fairly regularly. These noted the continued development of competition. For example, in July 2007 Ofgem reported vigorous price competition for all customers; innovation by suppliers in terms of fixed and capped price deals, cheaper online deals and green tariffs; improving customer service; and customer switching rates at their highest in four years.[13] On 16 January 2008, as noted, Ofgem issued its press release headed "Market is sound – Ofgem assures Chancellor".

2.2 Ofgem's Probe and the Non-discrimination Conditions

When, on 21 February 2008, Ofgem issued its next press release headed "Ofgem launches probe into energy supply markets", it was "in response to public concern about whether the market is working effectively". There was speculation as to whether Ofgem really believed there might be a problem with the market, or was just doing this to convince the public that the market was sound.

Ofgem's Probe reported *Initial Findings* in October 2008.[14] It did not find excessive profits: its conclusion was "assessment of suppliers' profitability is difficult" (p 114). Nor did it claim that competition was less effective than it had been: on the contrary, in the domestic gas and electricity markets

> "there are now greater levels of competitive activity and consumer switching than almost every other energy market in the world and most other UK consumer services markets. The fundamental structures of a competitive market are in place, and the transition to effective competitive markets is well advanced and continuing." (p. 5)

The report analysed and quantified the impact of competition on various key groups of customers, especially vulnerable customers. It concluded that many customers were not effectively engaged in the market and that competition was not developing fast enough.

> This interim report has found some important areas where the transition to competitive markets now needs to be accelerated. Many consumers are not yet benefiting fully from the competitive market and vulnerable consumer groups are disproportionately affected. (p 1)

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[10] "Ofgem's conclusion is that the best way of protecting customers' interests in the future is by vigorous use of its competition and consumer law powers rather than specific supply price controls. These powers will enable Ofgem to intervene to protect customers where appropriate." Ofgem 2002, *op cit*, Executive summary.

[11] Ofgem, 2003 *op cit*, p ii.

[12] Standard licence conditions put various obligations on suppliers with respect to the provision of information and response to customer queries about charges. In 2004 Ofgem noted concerns about one third of customers finding it difficult to compare prices, high levels of customer dissatisfaction over the calculation of bills and frequency of meter reads, and the importance of the right feedback to encourage energy efficiency. Ofgem concluded that it was appropriate to encourage the industry to work with the new consumer body energywatch to develop a billing standard to address these concerns. Ofgem, *Improving information for customers, An occasional paper*, July 2004.

[13] Ofgem, *Domestic Retail Market Report – June 2007*, London, 4 July 2007.

[14] Ofgem, *Energy Supply Probe - Initial Findings Report, 140/08, 6 October 2008*.

Ofgem proposed a package of measures to address these issues by "accelerating the transition" to effective competitive markets. These included actions to promote more active customer engagement and to help consumers make well-informed choices (e.g. via more and better information), to reduce barriers to entry and expansion (e.g. via suppliers publishing segmental accounts and by improving market liquidity), and to help small business consumers (e.g. by clarifying terms and conditions, and accrediting switching sites).

Ofgem's particular concern was differential pricing.

- "Until very recently, the five former incumbent electricity suppliers charged electricity customers in their former monopoly areas an average of over 10 per cent higher prices than comparable 'out-of-area' customers."
- "A number of the price differentials between payment types[15] do not appear to have a cost justification."
- "Overall, these price differentials mean that companies charge more to existing ('sticky') customers whilst maintaining competitiveness in more price sensitive segments of the market. The ability to price differentially in this way means that pressure on prices in the most competitive segments of the market does not always constrain prices for all other consumers." (pp 8-9)

To address its concern about price differentials, Ofgem proposed a requirement on suppliers that differences in charges for different payment types must be cost-reflective. Ofgem was "also considering placing a further new condition in the licences of the Big 6 suppliers that would either impose a prohibition on undue price discrimination or introduce a form of relative price control". This condition would "seek to ensure that price differentials are objectively justified by cost differences". (p. 15)

2.3 Features of the new approach

Ofgem's new policy generated considerable discussion and opposition, both in the energy sector and within Ofgem. The finding that there were price differentials was not new: previous Ofgem reviews had reported this, but had explained how competition was nonetheless protecting all groups of customers.[16] The concern with vulnerable customers was not new: Ofgem had previously drawn up a Social Action Plan "to ensure efficiency, choice and fairness in the provision of gas and electricity to disadvantaged customers",[17] Ofgem's June 2007 *Report* explained various additional steps that Ofgem was taking,[18] and the *Probe Initial Findings* describes Ofgem's "long history of involvement in these issues" (para 2.34), including a lengthy list of current initiatives to help vulnerable customers (para 9.18). Nor was the possibility of

[15] The three conventional payment types or methods are direct debit to a bank account, cash or cheque on receipt of bill, and prepayment via a top-up card.

[16] E.g. "Companies that are not delivering on price or service have been published by significant customer losses and churn. Suppliers who have charged uncompetitive prices in the regions where they used to have a monopoly have seen higher than average market share losses. … Where the incumbent has retained market share it is usually because they have offered competitive prices." Ofgem, *Domestic Retail Market Report - June 2007*, Ref 169/07, 4 July 2007, p 1.

[17] Offer/Ofgas, *Social Action Plan: Discussion Document*, May 1999.

[18] The section on Prepayment tariffs, fuel poverty, and vulnerable customers concluded with the sentence "We must ensure that the benefits of competition are extended to all customers, including PPM customers, vulnerable customers, and the fuel poor." Ofgem, *Domestic Retail Market Report - June 2007*, Ref 169/07, 4 July 2007, para 8.28, p 36.

imposing non-discrimination conditions new – Ofgem had repeatedly considered this in assessing whether or how to continue the initial transitional price caps.[19]

The *Probe Initial Findings* had a number of novel or at least distinctive features, which included the following.

- It presented a much more intensive and extensive analysis of the market than previous reviews (for example, 210 pages compared to 120 pages in 2004 and 56 pages in 2007).
- It analysed consumer segmentation according to switching behaviour (finding proactive 17%, reactive 37% and inactive 46%, per para 4.20) and reported considerable quantitative and qualitative customer research into consumer characteristics and behaviour, particularly regarding switching (hence, for example, the novel customer classifications such as confident deal seekers 16%, unhappy potential switchers 17%, under-confident and nervous 13%, loyalists 25%, disengaged 7% and older 23% per Table 5.1).
- It now quantified price differentials for different types of products and customers, compared these with cost differentials, and calculated the extent to which some customer groups were paying more than others, finding the total to be a large number (about £1 billion).
- For the first time, Ofgem characterised the existing price differentials as "unfair".
- It saw the market from a rather different perspective than before: it now emphasised that "The proportion of consumers who are proactively and confidently engaged in the energy market is relatively small" (p 59) and that "The potential numbers of vulnerable consumers are vast with around a quarter to a third of all customers being vulnerable in some way" (p 122).
- It considered that substantial lack of engagement impaired the market and was not likely to change: "The ability to price differentially in this way means that pressure on prices in the most competitive segments of the market does not always constrain prices for all other consumers" (para 1.18) "It is apparent that we cannot rely on switching by the active minority in energy supply to drive down prices for inactive consumers." (para 8.39).
- To "accelerate the transition to fully effective competition", Ofgem proposed no less than 20 new measures, grouped into 5 Actions, some potentially far-reaching (e.g. achieving a significant increase in wholesale market liquidity).
- In particular, Ofgem now proposed non-discrimination conditions, whereas it had previously rejected them.

In short, Ofgem looked at the retail market in more detail but did not find that competition was less effective than before. Rather, it took a different view of this competition. It previously argued that 'you pay a lower price if you shop around, so the market is working'. Now it argued that 'you pay a higher price if you don't shop around, so the market is not working'. The glass was now half-empty rather than half-full. The price differentials between more and less active

[19] Before the market opened, the Public Electricity Suppliers were subject to non-discrimination conditions that were to be relaxed as competition was established and removed when competition was effective. Offer, *Reviews of Public Electricity Suppliers 1998 to 2000, Price Controls and Competition Consultation Paper*, July 1998, p. 72. The role of non-discrimination conditions (including possible variants such as relative price controls) was discussed in Offer/Ofgas, *Review of Domestic and Small Business Electricity Supply Price Regulation: A Consultation Document*, June 1999 and in Ofgem, *Review of Domestic Gas and Electricity Competition and Supply Price Regulation: Evidence and Initial Proposals,* Nov 2001, paras 12.20–12.32, pp 106-110. The original non-discrimination conditions were removed when the Competition Act 1998 was introduced.

customers, which had always existed, were now deemed "unfair". Because of this different perspective, Ofgem decided to take drastic action.

Remarkably, it provided no discussion supporting the 20 proposed new measures. There was no explanation of why they were appropriate; no discussion of whether similar measures had been introduced, attempted or rejected before, and if so, what their effects had been and if not, why not; and no consideration of whether they might have potential downsides as well as upsides.

This was particularly surprising and unfortunate in the case of the proposed non-discrimination conditions. Between 1999 and 2002 Ofgem had twice considered non-discrimination conditions and variants such as relative price controls.[20] Both times it rejected them. Thus in June 1999 Ofgem pointed out that "knowing that a reduction in prices in the more competitive parts of the market would require it to cut prices in the less competitive parts of the markets, a PES [Public Electricity Supplier] might be less inclined to cut prices".[21] In October 1999 it noted that "a marker tariff in a portion of the market that is relatively unimportant to a company linked to a target tariff in a more important sector might discourage competitive behaviour towards marker tariff customers".[22] In 2001 it rejected relative price controls because tying the prices of a "target" group of inactive customers to the more competitive prices of a more active "marker" group of customers could provide an incentive to raise prices to the marker group instead of lowering them to the target group.[23]

Closer examination of the *Probe Initial Findings* suggests that in 2008 Ofgem was willing to introduce non-discrimination conditions (or relative price controls) because it was no longer concerned about avoiding an increase in the level of the "marker" group tariffs. In fact, it envisaged such an increase, as now explained.

2.4 Ofgem's analysis of differential prices and non-discrimination conditions

Ofgem took as a benchmark of the competitive price the standard dual-fuel direct debit (DF-DD) product supplied to 10.4m out-of-area customers, at a price of £1184 per annum for an average customer. However, it observed,

> We recognise, nonetheless, that DF-DD prices may currently be below competitive levels as a consequence of differential pricing, and may rise if price differentials are eliminated. We note that, based on financial data provided by the companies for 2005-2007, the average DF-DD product only just breaks even at the net profit level. (para 8.66 p 111)

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[20] Relative price controls involved identifying a "target" class of customers that needed to be protected and a "marker" class of customers for whom competition was expected to provide protection, then linking the target tariffs to the marker tariffs. (Offer/Ofgas, *Review of Domestic and Small Business Electricity Supply Price Regulation: A Consultation Document*, June 1999 para 9.2 p 72-3) The aim was to ensure that the benefits of competition were passed on to a wider group of customers.

[21] Offer/Ofgas, *Review of Domestic and Small Business Electricity Supply Price Regulation: A Consultation Document,* June 1999, para 9.2 p 73.

[22] Ofgem, *Reviews of Public Electricity Suppliers 1998-2000, Supply Price Control Review, Initial Proposals*, October 1999, para 2.22 p 14

[23] Ofgem, *Review of Domestic Gas and Electricity Competition and Supply Price Regulation: Evidence and Initial Proposals,* 2001 para 12.31; Ofgem, *Review of domestic gas and electricity competition and supply price regulation: Conclusions and final proposals*, February 2002, para 5.19.

By comparison with the DF-DD benchmark Ofgem calculated that various groups of other customers paid premiums totalling around £1 bn per annum.[24] Ofgem then acknowledged that this annual premium exceeded the average annual margin earned by the Big 6 retail energy businesses between 2005 and 2007. Ofgem did not say what this average was, but it appears to have been about zero.[25] Ofgem concluded that "if these differentials were eroded [as a result of regulatory action], it may be through a re-balancing between prices rather than by a straightforward decrease in price for the most impacted customers." (para 8.77)

Ofgem then calculated that, to rebalance the differentials while holding total revenue constant, "the annual cost of energy to a DF-DD customer would have to rise by around £40 per customer, or 3.5 per cent on the average dual fuel bill", and that using this new benchmark, "the impact would fall from £1 billion to around £550 million". (para 8.78) It said that "Although a rebalancing of this type would not reduce average prices paid by consumers it would disproportionately benefit vulnerable groups."

In short, some customers (including some vulnerable customers) would benefit by a total of £550m, but other customers (also including some vulnerable customers) would be worse off by £550m. Ofgem's proposal was not to enable the vulnerable customers to achieve the prices previously paid by the less-vulnerable customers: Ofgem accepted that prices to the latter would rise. It was a simple redistribution of income. To justify Ofgem's policy and keep suppliers' margins constant, it was not enough that some customers be made better off: other customers had to be made worse off to the same aggregate extent. All customers had to pay the same price (unless the difference was "objectively justified by cost differences").

This may explain why Ofgem now paid little heed to its previous reservations about imposing non-discrimination conditions. The aim was no longer to enable customers in a less competitive part of the market to obtain the benefits of competition. Now the equalisation of prices was an end in itself, regardless of the possible adverse effects on other customers and on competition.

2.5 The contrast with conventional economic analysis

Why did Ofgem consider that DF-DD prices might be below competitive levels as a result of differential pricing? It was not because DF-DD products were priced below direct cost: that would make no commercial sense and the companies' financial data cited above showed that the product just broke even.[26] It was because DF-DD tariffs made little or no contribution to overheads, which were covered by the higher contributions from other tariffs. Ofgem's calculation suggests that overheads in the sector amounted to about £1 bn per annum (about £20

[24] Para 8.76. The details of this total are not easy to calculate. It seems that it comprised 4.3 m customers off the gas grid £240m (about £55 per customer or per account); 15.8m customer accounts remaining with former incumbent suppliers £585m (about £37 per account, or £74 per customer) plus 2m customers (4m accounts) who have switched but don't have the same supplier for both fuels about £68m (about £34 per customer, or £17 per account, calculated as 3% of £1134m x 2m customers, to reflect a premium of between 2 and 4% per para 8.72); 10.9m Standard Credit customers £140m (about £13 per customer, or £6.50 per account). This made a total of about £1033m for 25.1m customers (an average of about £53 each) or 45.9 customer accounts.

[25] Ofgem's Figure 8.1 (p 100) suggests that, in very round figures, the net margin in electricity supply increased from about £250m in 2005 to about £500m in 2006 and to £750m in 2007, while in gas supply it remained at about (minus) £500m. This implied an aggregate net supply margin that increased from about (minus) £250m in 2005 through zero in 2006 to about (plus) £250m in 2007, an average of about zero over 2005 to 2007. This compared with an aggregate net supply margin of about £2000m in the earlier period from 2000 to 2004.

[26] See also "No tariffs were offered at a price consistently below cost. Online tariffs which were below cost initially were introductory offers only." Ofgem *Impact Assessment* April 2009 para 5.33 and fn 27, p 20

per customer account averaged over all 49.1m accounts for gas and electricity). Ofgem's assumption was that a "competitive level" required all products to have an equal markup towards overheads. This is why the DF-DD prices were too low and had to be increased.

There is no economic basis for assuming that competition will be characterised by equal markups. The latter may correspond to some concept of "fairness", or bureaucratic or political convenience, but they bear no correspondence to commercial reality. Any business knows that some of its products and markets have more or less elastic demand than others, for a variety or reasons, regardless of how well informed and engaged its customers are. A business sets prices accordingly to recover its overheads. Equal overheads on all products would be a transitory fluke.

A growing economic literature demonstrates that price differentiation can be competitive rather than monopolistic.[27] It reaches a strong conclusion.

> … in a broad ranch of market types and conditions, where consumers can be separated into distinct groups with different demand elasticities and in which the market's commodity cannot easily be resold by one group to another, market pressures will prevent any equilibrium in which the product price is uniform. Not only will each firm be *forced* to adopt discriminatory prices, but each firm is likely to be forced to adopt a unique vector of prices, each of which is dictated by the market. Thus this paper seeks to show why price discrimination may occur – and may occur frequently - not despite relative ease of entry (of other competitive pressures) but because of it. In fact, I will show that in highly competitive markets, *firms may have no choice. Competition can force them to adopt the vector of profit-maximizing discriminatory prices*.[28]

The assumptions involved in this analysis – customer groups with different demand elasticities, no easy resale, and overhead costs to recover - characterise the retail energy sector. In other words, contrary to Ofgem's assumption, differential pricing is not a sign that the retail energy market is not yet effectively competitive. On the contrary, it is consistent with that market being very competitive indeed – particularly when, as Ofgem found, the average annual net retail margin in the industry was approximately zero.

It is true that customers who shop around would generally pay less than those who do not, but such price differentials are not a sign of lack of competition. In consequence, policy designed to prevent such differential pricing would not hasten the transition to a more competitive market, nor merely disrupt that transition. It would actually *prevent* a competitive market by imposing a concept of a "fair" outcome which is different from what a fully competitive market would entail.

The price differentials in the competitive market described are an economically efficient way of recovering the overhead costs (given the demand elasticities). [29] It follows that, even if prices that just recovered total overhead costs with equal markups could be imposed on the sector, this would represent not only a less competitive outcome for the sector but also a less efficient one.

[27] See, e.g., Kenneth S Corts, "Third degree price discrimination in oligopoly: All-out competition and strategic commitment", *The RAND Journal of Economics*, 29(2) Summer 1998: 306-323; Michael E Levine, "Price discrimination without market power", *Yale Journal on Regulation*, 19(1), 2002, 1-36.

[28] William 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, pp 2-3, italics in original.

[29] "… in equilibrium, these discriminatory prices are not haphazard in their welfare properties but will generally constitute a Ramsey optimum" (Baumol op cit p 3) .

In practice, of course, Ofgem had no way of imposing such prices. What it did was require prices to be equal (allowing for cost differences). That does not necessarily mean that the higher prices for the target products will be brought down to the level of the benchmark (marker) product. As Ofgem itself had pointed out in 1999 and 2001 (see above), it is possible that the price of the benchmark product will instead be increased to levels comparable with the target products. This is likely if the benchmark is the smaller volume and more competitive market with more elastic demand relative to the target market. In simple terms, if suppliers were required to equalise their prices it was more likely that they would increase their prices out of area than reduce their prices in-area. For that reason, Ofgem had previously decided against non-discrimination and relative price controls.

Thus, for all its detailed insights into how the retail market was operating, and its concern for vulnerable customers, the *Probe Initial Findings* got Ofgem into four significant difficulties.

- First, it interpreted the differential prices that it observed as indicative of a market that was not competitive, whereas they were more plausibly indicative of a market where competition was very effective (albeit with some customers more active than others).
- Second, it presented its proposals to remove these differentials in such a way as to imply that then-existing higher prices would be reduced to the level of then-existing lower prices, so that vulnerable customers would see a net gain of £500m, whereas the detail of its explanation revealed that the proposal was to reduce the higher prices by £500m and at the same time to increase the lower prices (for dual fuel direct debit) by £500m, leaving customers as a whole no better off – and some customers worse off.
- Third, it expected to achieve this zero net revenue rebalancing by means of non-discrimination conditions, whereas Ofgem itself had previous explained why this was not a plausible outcome, at least for in-area versus out-of-area pricing, and that a more likely outcome was an increase in the lower (out-of-area) prices, perhaps without any reduction at all in the higher (in-area) prices.
- Fourth, despite devoting a chapter to consumer switching and its drivers, and concluding that "the single largest factor affecting a supplier's churn rate is its relative price" (para 4.14), the *Probe Initial Findings* gave no consideration to what if any impact its proposed non-discrimination policy – aimed at reducing relative prices - would have on customers' engagement in the market and hence on competitive pressures on suppliers.

2.6 Responses to the Probe consultation

Ofgem's *Probe Initial Findings* were put out to consultation. Even before this was complete and formal licence modifications were in place, suppliers began to adjust their prices to meet these prospective requirements. By December 2008 "Ofgem's energy market probe is on track to remove more than £500 million in unfair premiums from suppliers' tariffs, but Ofgem wants speedier action".[30] It explained that "the six main energy suppliers have pushed ahead towards stripping more than half a billion pounds in unfair pricing from energy bills". It did not explain that Ofgem expected them equally to push ahead stuffing the stripped out half a billion pounds back onto energy bills of other customers.

[30] Ofgem press release R 35 16 December 2008. The breakdown was higher prices in-area than out-of-area £181m, prepayment meter differentials £96m, higher prices for customers not on the gas grid £55m, total £332m, plus another £200m to come from further reducing off-gas-grid differentials.

Ofgem's consultation on *Addressing unfair price differentials* in January 2009 [31] set out a range of proposed formulations for these licence conditions. An Appendix (rather than the main text) indicated that "the erosion of price differentials may [sic] be through a rebalancing of prices rather than by a straightforward decrease in price for the most impacted customers". (Appendix 2 para 1.7) An estimate of expected price reductions and increases assumed that the rebalancing would be revenue neutral.[32] In practice there was a risk of an overall increase in margins. But "it is also possible that the more competitive segments of the market will provide an effective discipline on the less price-sensitive segments of the market, leading to a net reduction in the average level of prices". (Appendix 2 para 1.39) It was noted that "intervention runs the risk of undermining competition and innovation … [and] could lower the incentives for consumers to switch". (Appendix 2 para 1.22) But it was also possible that competition could improve competitive pressure in some ways, by disciplining suppliers and making market entry profitable. (Appendix 2 para 1.24) In sum, Ofgem proposed to go ahead, and any possibility of adverse outcomes was argued to be balanced by the possibility of more favourable outcomes.

But were these possibilities evenly balanced? In February, Waddams submitted evidence that "There is a considerable body of economic analysis and literature which indicates that prevention of such price differences is likely to harm competition in the market; and there is little evidence that it will necessarily help vulnerable customers."[33]

In March, the Gas and Electricity Markets Authority GEMA (the governing body of Ofgem) held a special meeting to discuss and agree its policy on retail regulation. Professor Yarrow, the economist Non-Executive Director on GEMA, argued against the non-discrimination conditions. He failed to persuade his colleagues and resigned.

In April, Ofgem issued for consultation its final proposals on undue discrimination,[34] together with an *Impact Assessment* that devoted several pages to discussing the theoretical economic literature on price discrimination.[35] (It also explained the statutory basis for its approach to undue discrimination.[36]) It acknowledged, in a fuller and more open way than any other Ofgem document before or since, the potential downsides of its proposed policy. It accepted that, "where suppliers have different strong and weak markets to each other, price discrimination can

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[31] Ofgem, *Addressing unfair price differentials*, Ref 01/09, 8 January 2009

[32] "1.14. Based on September 2008 data, if 'in area' and 'out-of-area' electricity prices (net of network charges) were equalised in a revenue neutral manner, we would expect prices for around 8 million 'in area' customers to fall on average by around 1.5 per cent (or £6 off the average annual bill). Many of these consumers will be off the gas grid, live in rural areas and are more likely to be fuel poor. For around 2.5 million 'out-of-area' customers, prices would be expected to rise on average by around 5 per cent (or £18 on the average annual bill)."

[33] *Addressing unfair price differentials: Response to Ofgem's consultation*, from Catherine Waddams, Centre for Competition Policy, University of East Anglia, 19 February 2009. She also argued, inter alia, (1) that preventing 'unfair price differentials' between regions "would deal a damaging, and probably fatal, blow to competition". (2) that constraints on unfair differentials are an ineffective way of assisting vulnerable households: "As Ofgem points out, 'the majority of vulnerable groups are not prepayment meter users (Probe para 5.2): this majority would pay higher prices as a result of restricting differentials between prepayment and other means, because other tariffs would rise". (3) "The proposals seem inconsistent with the objective of 'making competition in the retail markets work effectively for all consumers'. (consultation para 1.3)"

[34] Ofgem, *Addressing Undue Discrimination – final proposals*, Ref 42/09, 15 April 2009.

[35] Ofgem, *Addressing undue discrimination – Impact assessment*, Ref 43/09, 15 April 2009.

[36] *Ibid*, paras 2.6-2.7, p 3. Ofgem took into account not only its principle objective – to protect the interests of customers wherever appropriate by promoting effective competition – but also its other statutory duties. These included contributing to the aims of sustainable development, which principles included "ensuring a strong, healthy and just society"; having regard to the interests of vulnerable customers; and having regard to the social and environmental guidance issued by the Secretary of State, which included achievement of the Government's fuel poverty targets in respect of vulnerable consumers.

lower prices universally by increasing competition in every market segment. In these circumstances, prohibiting price discrimination could increase prices for all consumers". (para 5.19 p 17) It accepted that the policy could facilitate tacit collusion (now called coordination).[37] However, there were many potential considerations, and "the net effect on welfare is ambiguous". (para 5.34 p 20) Ofgem concluded:

> "Our assessment is that these measures will have significant benefits for many vulnerable customers in the form of lower prices. [It did not mention that the measures would have significant disbenefits for other customers (also including some vulnerable customers) in the form of higher prices.] … The impact on competition of these licence conditions is ambiguous, with potential upsides and downsides. … the fact that licence condition B [non-discrimination between regions] is intended to operate only for a limited period further mitigates some of the potential risks to competition. Given our statutory duty to protect the interests of customers, and to have regard to the interests of vulnerable customers in particular, we have attached more weight to the benefits to vulnerable customers." (paras 11.2-11.5)

Experienced independent economists did not accept that the impact on competition was ambiguous or that this policy would be in the interests of customers. Responding in May, Professor Waddams, then a member of the Competition Commission, reinforced her earlier submission, saying that the proposed undue discrimination clause "is likely to stifle competition".[38] Sir John Vickers, recently retired as Director General of Fair Trading, was equally forthright about this "bad policy".[39] Professor Yarrow, former Non-Executive Director of GEMA, referred to the professional consensus that the proposals would have "harmful consequences for consumers and for competition".[40] Ofgem's June *Decision Document* noted that "three academics" were strongly opposed to the licence condition,[41] but the *Final Impact Assessment* was essentially unchanged.[42]

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[37] "5.67. Our proposed licence conditions may have implications for suppliers' ability to monitor competitors' behaviour. In particular, if licence condition B reduces the level of differential pricing between regions, it could simplify pricing strategies and may make it easier for suppliers to monitor their competitors" behaviour. The easier it is to detect deviation from a collusive strategy, the less attractive deviation becomes. It is possible that the risk of collusion becoming a viable strategy may increase following the implementation of our proposed licence conditions. We will continue to monitor the market and were we to find evidence of such collusion we would be able to take action in accordance with our powers under the Competition Act 1998." (Ofgem, *Addressing undue discrimination - impact assessment*, Ref 43/09, 15 April 2009, para 5.64 p 24.)

[38] Professor Catherine Waddams, University of East Anglia, *Addressing undue discrimination: final proposals: response to Ofgem's consultation*, 13 May 2009. "The impact assessment recognises potential dangers to competition, but continues to underestimate them. Even in the short term, it is unlikely that any consumers will benefit from these measures. …While the differentials in prices will disappear … the removal of competitive pressure is likely to maintain prices at a higher level than they would otherwise have reached, with detrimental effects on all consumers, including those defined as vulnerable, in both the short and long term."

[39] "I believe that the proposals are likely to be detrimental to consumers and therefore bad policy. Banning price discrimination stops important kinds of price competition − for example, regional incumbents challenging one another − and so perversely can blunt competition and help firms sustain higher prices to consumers in general. I urge Ofgem not to score this own goal." Professor Sir John Vickers, *Assessing undue discrimination, Response to Ofgem Consultation*, 1 May 2009.

[40] "There is almost a consensus among economists familiar with competition and energy market issues that, on the basis of best available knowledge, Ofgem's proposals to "address undue discrimination" can be expected to have harmful consequences for consumers and for competition." Professor George Yarrow, *Response to Ofgem's consultation*, 11 May 2009.

[41] Ofgem, *Addressing undue discrimination: Decision Document*, Ref 72/09, 26 June 2009, para 1.8 p 2.

[42] Ofgem, *Addressing undue price discrimination - Final impact assessment*, Ref 73/09, 26 June 2009.

In September 2009 two non-discrimination obligations were formally implemented as Standard Licence Conditions SLC 25A (referring to in-area versus out-of-area prices) and 27.2A (referring to different payment types).

2.7 The sunset clause

The non-discrimination condition between regions (SLC 25A) was the subject of a sunset clause: it would fall away after three years unless steps were taken to reimpose it. Ofgem initially argued that it would take three years for the condition to take effect. It later explained that the three year sunset clause was "intended to limit the duration of any potential negative impact on competition".[43] In introducing the licence conditions in September 2009 (and subsequently), Ofgem said that "We are also committed to a thorough review of the impact of the measures introduced as a result of the Probe, before SLC 25A terminates at the end of July 2012."[44] One would have expected such a thorough review to evaluate the contrasting predictions of the effect of the non-discrimination conditions against the accumulating empirical evidence. This did not happen.

In November 2010, a little over a year after implementing its September 2009 reforms, Ofgem announced its intention to review again the effectiveness of the retail energy market – its so-called Retail Market Review (RMR).[45] The *Findings* of this review in March 2011[46] did not address the contrasting predictions of the impact of the non-discrimination conditions. In December 2011 Ofgem proposed further measures (discussed below).[47] In February 2012 it proposed to review the extent to which condition SLC 25A was necessary only "after any relevant RMR proposals have been properly implemented".[48] It therefore proposed to take steps to prevent the sunset clause lapsing, and to renew it for two years, without any examination of the effects it was having.

I argued against this, on the grounds that Ofgem had not considered the available evidence on the effects of introducing the condition; this evidence suggested that the condition had numerous adverse effects; and continuing the condition without reviewing it as promised was inconsistent with due regulatory process.[49] After further consideration, Ofgem decided to allow the sunset clause to lapse in July 2012 as originally planned. However, it did so with a strong warning to

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[43] Ofgem, *Addressing undue price discrimination - Final impact assessment*, Ref 73/09, 26 June 2009, at para 5.71 p 27 and para 11.4 p 40.
[44]E.g. Ofgem, *Update on probe monitoring*, 1 July 2010, para 4.4 p 23.
[45] *Ofgem to review the effectiveness of the retail energy market to see if further action is needed to protect consumers*, Ofgem Press Notice R/18, 26 November 2010
[46] Ofgem, *Retail Market Review – Findings and initial proposals*, Ref 34/11, March 2011.
[47] Ofgem, *Retail Market Review – Domestic proposals*, Ref 166/11, December 2011.
[48] Ofgem *Consultation*, Ref 23/11, 24 February 2012.
[49] Stephen Littlechild, Protecting customers or suppliers? A response to Ofgem's consultation on its *Retail Market Review – Updated domestic proposals*, 21 December 2012.

suppliers not to resume differential pricing.[50] They might reasonably have assumed that SLC 25A effectively remained in place, as indeed one supplier has since testified.[51]

This little episode suggests that despite – or perhaps because of – the different views concerning the possible impact of the non-discrimination clause, Ofgem was more anxious to keep the clause in place than to learn what effects it might have had. It is to be hoped that the CMA market investigation will examine and shed light on these effects, not least on whether, given the wide range of customer circumstances and consumption levels, the resulting prices are actually "fairer" than the pre-intervention ones.

2.8 The effect of the non-discrimination condition on prices and switching

Economists predicted that the non-discrimination condition would lead to higher prices and less competition which in turn would imply higher profits for suppliers. Ofgem maintained that the outcome was ambiguous. From the beginning, Ofgem has highlighted the reduction in differentials but has not otherwise examined the effects of the condition. Nor, since the impact assessments in 2009 has it acknowledged the possibility of any substantial disadvantages of that condition. What evidence have others adduced?

Green noted "a large increase in the level of the average bill at almost exactly the same time that companies started to reduce their cross-region differences". [52] This suggested that the lower differentials were a result of increasing the lower out-of-area prices rather than reducing the higher in-area prices.

The average difference between the incumbent supplier's price and the best-priced non-incumbent roughly halved after 2009.[53] This would explain the significant reduction in customer switching since the non-discrimination conditions were introduced. "Switching rates have fallen, confirming widespread evidence that potential price gains are the main drivers of consumer activity in the residential energy market."[54]

Figure 1 shows the extent of customer switching over the last decade. The number of electricity plus gas transfers between suppliers increased from 1.7m in first quarter 2003 to 2.6m in third

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[50] "We therefore would expect suppliers to continue to have regard to the spirit of our [RMR] proposals and their own individual voluntary commitments when considering pricing strategies, particularly where they may differ between out-of-area and in-area customers. While we have decided not to re-insert SLC 25A for a further period, we will be monitoring very closely the pricing practices of all suppliers as part of our general market monitoring activities. If at any time we have compelling evidence to suggest pricing practices which are unjustified are returning to the market, we may commence a full review of this area and consider developing new licence conditions to address our concerns." Ofgem, *Decision on Standard Licence Condition 25A in the Gas and Electricity Licences*, 26 October 2012.

[51] RWE, *Energy Market Investigation Reference, Initial Submission*, 30 July 2014.

[52] R Green, *Response to Ofgem consultation*, 10 April 2012.

[53] Catherine Waddams Price and Minyan Zhu, "Pricing in the UK Retail Energy Market, 2005 to 2013", Working Paper, ESRC Centre for Competition Policy, University of East Anglia, December 2013, p 15; forthcoming as "Non-discrimination clauses: their effect on GB retail energy prices", *The Energy Journal*, 2015, at Fig 3.

[54] Waddams Price and Zhu, *op cit* p 9. References cited are Ofgem, *Energy Supply Probe – Initial Findings*, 6 October 2008, p.152; Giulietti, Monica, Catherine Waddams Price, and Michael Waterson, 2005. "Consumer Choice and Competition Policy: a Study of UK Energy Markets." *The Economic Journal* 115.506: 949-968; Flores, M. and Waddams Price, C., 2013. *Consumer behaviour in the British retail electricity market*. Centre for Competition Policy working paper 13-10 http://competitionpolicy.ac.uk/publications/working-papers-2013. Waddams Price, Catherine, Catherine Webster and Minyan Zhu, 2013. *Searching and switching: empirical estimates of consumer behaviour in regulated markets*, Centre for Competition Policy working paper 13-11, December 2013.

quarter 2008 then decreased to 1.1m in third quarter 2013, less than half the 2008 peak. (The spike to 2.3m in first quarter 2014 is thought to be a temporary reaction to "the recent media and political attention on retail energy prices and their increases over this period since October 2013".[55])

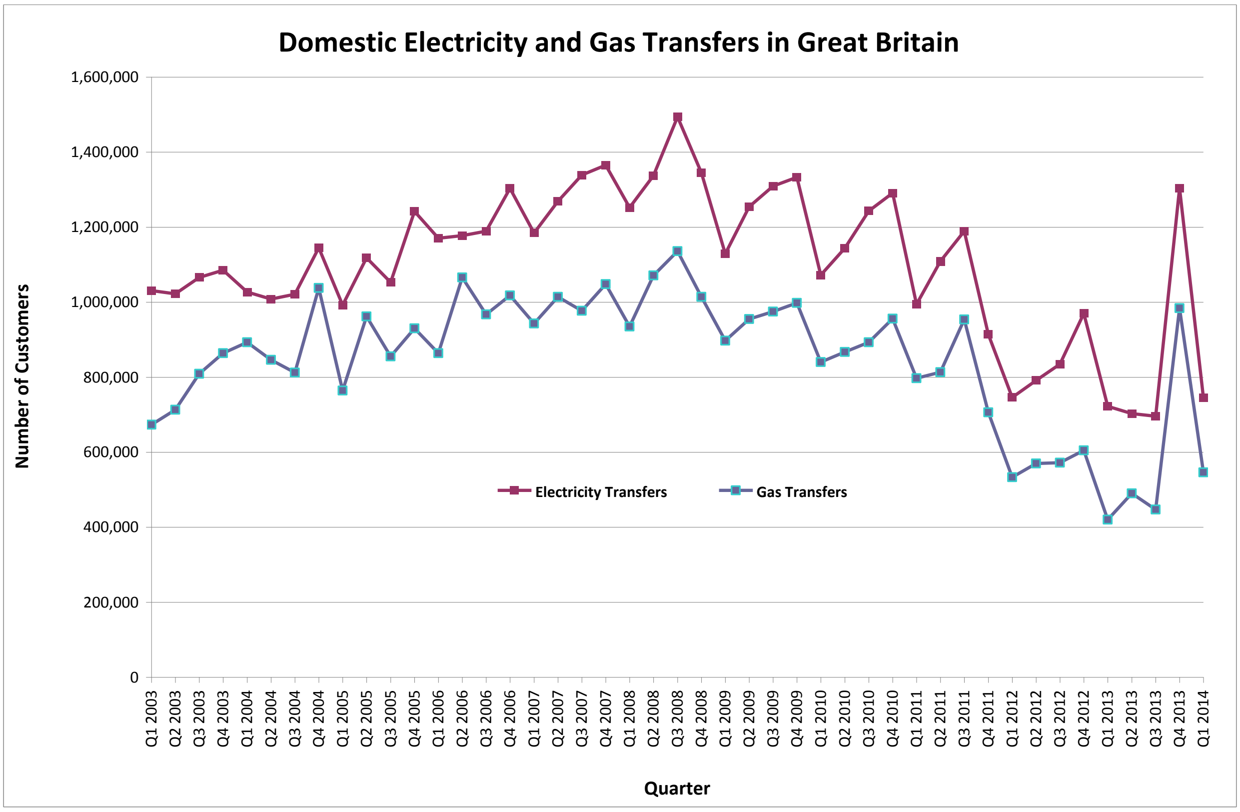

Figure 1 The increase then decrease in customer switching[56]

The major suppliers had previously found doorstep selling the most cost-effective means of attracting customers. It is therefore sometimes suggested that the cessation of doorstep selling – a cessation that Ofgem came to encourage, despite the fact that doorstep selling was particularly effective in reaching customers that might not otherwise engage in the market – explains the fall in switching. However, it was not until July 2011 that the first supplier abandoned doorstep selling, by which time the decline in switching had been underway for over two years. Four more suppliers followed by October 2011, and the last (smallest) supplier ceased doorstep selling in July 2012, after which switching continued to decrease for another two years.[57] Thus, the end of doorstep selling does not explain the much longer decline in customer switching. [58]

[55] *State of the market assessment*, para 3.16 p 27.

[56] Source: DECC, Quarterly Energy Transfer statistics for the gas and electricity markets in Great Britain, 26 June 2014.

[57] The significance of doorstep selling was actually declining before the companies ceased the practice, while the use of online comparison sites was increasing. "In 2009, 33% of gas customers found out about their last switch through door step sales (compared with 41% in 2008) and 26% via an online comparison site (compared with 21% in 2008)." Ofgem, *Update on probe monitoring: tariff differentials and customer switching*, 1 July 2010, para 3.7, p 21. It seems conceivable that the non-discrimination conditions reduced the effectiveness of doorstep selling relative to online selling methods, and hence brought forward the cessation of doorstep selling.

[58] It might be argued that, if the non-discrimination condition were the explanation for the fall in switching, then switching should have increased again after the condition was removed in July 2012. However, as noted above, Ofgem clearly indicated that suppliers were to behave as if the condition were still in place, which they have done.

An early empirical study by Hviid and Waddams Price confirmed the predictions of economists about the impact on competition.[59] A subsequent and more detailed econometric analysis by Waddams Price and Zhu finds that "the non-discrimination condition has changed the nature of competition", that "the constraint on incumbent price increases has weakened" and that "each regional market is [now] closer to a duopoly between the regional incumbent and British Gas".[60] They conclude: "So while equity may have improved, this is likely to have been at the 'absolute' expense of just those consumers whom the regulator sought to protect."[61]

2.9 The effect on rivalry between major suppliers

The reduction in competition at the aggregate level seems to be reflected in the reduction in changes in market shares of the major rival suppliers. There were two striking features of the domestic market in the 4½ year period January 2004 to June 2008. (1) The fall in market shares of the largest supplier British Gas (Centrica): from 24% to 22% in the electricity market and from about 59% to 44% in the gas market, an aggregate reduction in market share of about 2 + 15 = 17 percentage points. (2) The increase in market shares of supplier SSE: from about 13% to 19% of the electricity market and from about 7% to 15% of the gas market, an aggregate increase in market share of about 6 + 8 = 14 percentage points, taking SSE from fourth to second largest supplier.[62]

In contrast, in the 4 year period June 2008 to June 2012, the comparable changes were as follows. (1) British Gas went from 22% to 25% in electricity and from 44% to 42% in gas, an aggregate net increase of 3 – 2 = 1 percentage point. (2) SSE stayed at 19% in electricity and went from 15% to 17% in gas, an aggregate net increase of 0 + 2 = 2 percentage points.[63]

The sum of the absolute changes in market shares was 17 + 14 = 31 percentage points in the first period and 1 + 2 = 3 percentage points in the second period. Rivalry in the market, as reflected in changing market shares of the largest two suppliers, sharply diminished after 2008. By this admittedly crude measure, rivalry fell to a tenth of its former level.

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[59] "From the literature on price discrimination in oligopolistic markets, summarised by Stole (2007) and Armstrong (2008), a robust finding is that banning price discrimination will raise some and possibly all prices in the market." Hviid and Waddams (2010) p 2. "… the most likely net result of prohibiting geographical discrimination on prices is to raise them all, as predicted by the theoretical literature … Although price differentials have fallen, the rising levels of both gross and net margins since the clauses were introduced provide evidence that this has occurred." M Hviid and C Waddams Price, "Non-discrimination clauses in the Retail Energy Sector", *The Economic Journal*, Vol 122, August 2012, F236-252. They also note that Ofgem "found many indicators that competition had deteriorated in its 2011 Retail Market Review. These would follow from the weakening competitive threat from the entrants in each region."

[60] Catherine Waddams Price and Minyan Zhu, "Pricing in the UK Retail Energy Market, 2005 to 2013", Working Paper, ESRC Centre for Competition Policy, University of East Anglia, December 2013, p 15; forthcoming as "Non-discrimination clauses: their effect on GB retail energy prices", *The Energy Journal*, 2015.

[61] "Ofgem's introduction of the NDC [Non-Discrimination Condition] was primarily on equity grounds, to prevent companies from charging higher prices to inactive consumers in their home regions. While the differential between the standard tariffs levied in different regions has indeed fallen, the increasing profits indicate that this levelling is almost certainly at the cost of consumers out of region, rather than through lower prices to those sticky customers at home. Indeed the increase in profits by around £100 per consumer, compared with an average price differential before the NDC of less than £30, suggests that all consumers are paying higher prices as a result." Waddams Price and Zhu, *Ibid.* p 16.

[62] Ofgem, *Energy Supply Probe – Initial findings report*, 6 October 2008, Figures 3.1, 3.2, pp 32-3.

[63] *State of the Market Assessment*, Figures 3 and 4, pp 8 – 9.

What is the explanation for SSE's change to a less aggressive policy after 2008? SSE has now said that it adjusted its strategy in 2008 as a result of Ofgem's change in policy.[64] So Ofgem's non-discrimination policy seems to have been responsible for significantly reducing rivalry between the two largest suppliers in the retail market.

2.10 The effect on suppliers' profits

What has been the extent of increases in supplier profits potentially attributable to Ofgem's restrictions on competition? Ofgem's segmented accounts data show that, in the domestic (household) market, earnings before interest and tax (EBIT), for the big 6 suppliers combined, increased from £233m in 2009 to £1190m in 2012.[65] They remained at £1133m in 2013. This is an increase of nearly £1 bn over three years. In parallel, there was a striking increase in profit margins. "EBIT Margins in combined domestic supply have increased over the period from 0.9 per cent in 2009 to 4.3 per cent in 2012."[66] They are at 3.9% in 2013.

Ofgem calculates an indicator of energy supply net profit margins, which "provides an indicator of margins from supplying energy to a typical customer, rather than an estimate of energy supply company profits." For a dual fuel customer, from late 2006 to mid-2008 this margin averaged about (minus) £35. Then it began to increase, becoming positive about mid-2009, about £40 from early 2010 to mid-2012, and around £100 or more in 2013 onwards.

I have elsewhere calculated how far these net profit margins increased after the imposition of Ofgem's non-discrimination conditions.[67] Using Ofgem's rolling net margins (which take an average over 12 months), I took as the pre-Probe benchmark the year ending February 2008, and calculated the increases in this margin to the year ending February 2014 (using Ofgem's forecasts for the last year).

Ofgem's net margin figures suggest that suppliers' profits in aggregate, from dual fuel and single fuel energy supply, were higher by £0.9bn, £2.0bn, £1.9bn and £1.9bn in the years ending February 2010 to February 2013, than in the year ending February 2008. Admittedly Ofgem's net margin calculations have been criticised by the suppliers, and my own calculation depends somewhat on the precise dates chosen.[68] Nevertheless, Ofgem's net margins data suggest that the increase of nearly £1bn shown by the segmented accounts data could be an underestimate of the costs to customers of Ofgem's policy, including compared to a calculation beginning a year earlier and continuing a year or two later. Further calculations would seem in order, not least to reconcile the messages given by these two different sets of regulatory data.

[64] "SSE told us that some [tariff balancing] changes were made in 2008 due to the Probe as SSE's gas business was loss-making at that time and Ofgem's changes introduced an effective prohibition on cross-subsidisation." *State of the market assessment*, para 6.27 p 109.

[65] *State of the market assessment*, para 6.10 and Figure 44, pp 101-2. Over the same period, combined generation and supply EBIT increased much less, from £3070m to £3735m.

[66] *State of the market assessment, Ibid*, para 6.25, p 108. "However, this is made up of a small decline in domestic electricity margins (from 2.2 per cent to 1.8 per cent) and a significant increase in domestic gas margins (from -0.3 per cent to 6.7 per cent)." Aggregate of individual suppliers' segmented accounts for 2013.

[67] Stephen Littlechild, *Response to Ofgem consultation*, 21 December 2012, pp 22-23.

[68] If the year ending February 2009 is taken as the base instead of February 2008, the figures cited reduce by £0.3bn. For the year ending February 2014, admittedly based on estimates, the estimated increase was £2.9bn. The total over the six year period amounted to some £10 bn.

Other calculations give a similar message. Recent data on prices, costs and margins[69] show Gross Margin averaging around £100 from 2004 to 2008 then increasing to about £300 in 2013.

Meanwhile, the contrast between Ofgem's aspirations and the outcome is evident. In December 2008 Ofgem announced that it had removed "unfair differentials" amounting to over £300m and had £500m in its sights, all the while envisaging that suppliers' revenue would remain constant. It is now apparent (consistent with what economists had predicted beforehand) that this policy of "eliminating unfair differentials" has not only led to an increase in the lower prices without a reduction in the higher prices, but seems to have increased all prices by a total of about £1 billion – or perhaps up to twice that if Ofgem's net margin figures have any credibility.

2.11 The effect on new entry

What effect would the non-discrimination policy be expected to have on entry? If the retail market were competitive before 2008, and the new policy reduced competition and increased profits, it would attract new entry after 2008. This is what we observe. New entry was minimal before 2008 and in aggregate never amounted to more than 1% of the domestic (household) market. Now there is significant growth of small suppliers, amounting to over 6% of the market, and it began to take off in 2009, as illustrated in Figures 2 and 3.

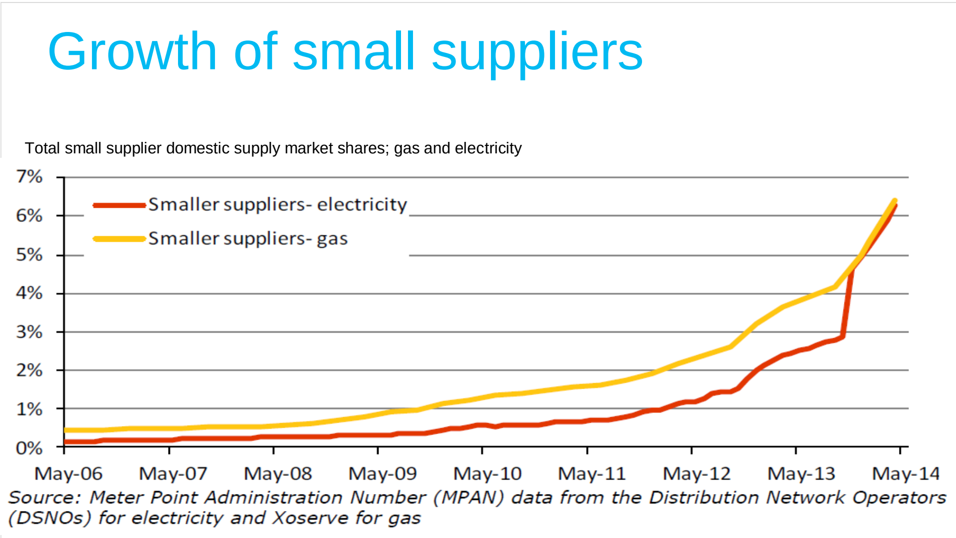

Figure 2 Growth of small suppliers

[69] *State of the Market Assessment*, Figure 36, p 73.

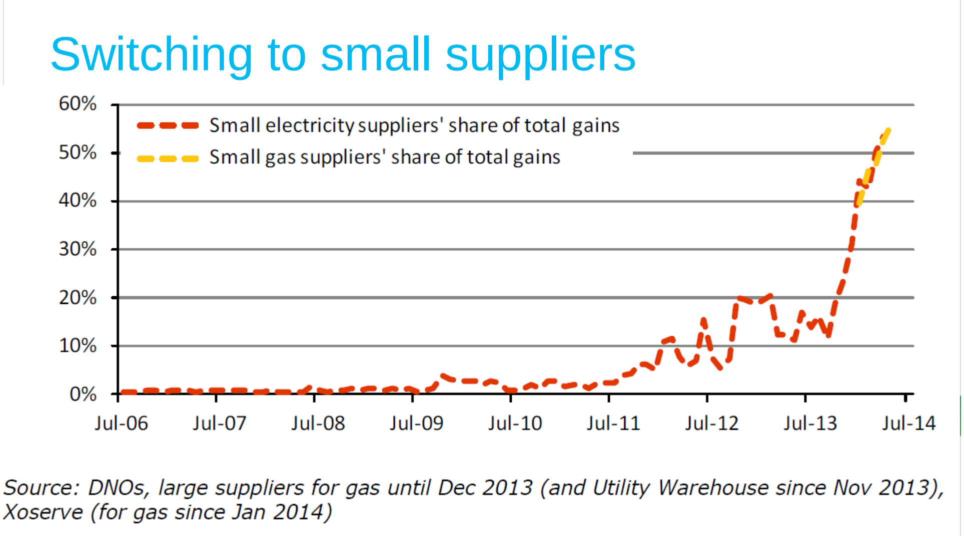

Figure 3 Switching to small suppliers[70]

Admittedly, small suppliers including new entrants are exempt from certain environmental and social policy costs until they have 250,000 customer accounts. (A Big 6 supplier would have between about 5 and 16 million accounts.) In effect this provides a subsidy to smaller suppliers, but also a barrier to their expansion above 250,000 accounts. The Government's December 2013 measures (see section 4.5 below) roughly halved the size of this subsidy and barrier, but they are still considerable. The advantage is about £90 on a duel fuel bill after the December 2013 reductions.[71] This is at a time when the cheapest dual fuel bill is about £1100, the savings from switching from an incumbent single fuel supplier to the best competing Big 6 supplier is nearly £100, and the average Big 6 EBIT margin in 2012 was about 4.3%, or about £47 on an £1100 bill.[72] The impact of the exemptions and reductions therein may thus impact on competition, new entry and the growth of existing entrants.

Although the net effect is as yet unknown, four small suppliers have now gone through the 250,000 barrier and are no longer subsidised in this way. This suggests that at least part of the increase in new entry is attributable to an increase in industry profit margins.

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[70] Source for Figs 2 and 3: Ofgem, *Decision to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain: Final decision*, 26 June 2014, Figures 1 and 2.
[71] *State of the market assessment*, p 80.
[72] *State of the Market Assessment*, Fig 17, p 41; para 1.24, p 11; para 6.25, p 108. Ofgem's retail margin calculation puts the dual fuel margin nearer £100. The Big 6 EBIT margin was lower in 2013.

3. Ofgem's Retail Market Review and subsequent developments

3.1 Ofgem's Retail Market Review

Ofgem's stated view in designing and presenting its September 2009 reforms was that it would take at least three years for them to take effect. However, little over a year later, noting a 38% increase in net retail profit margins, it announced its intention to review again the effectiveness of the retail energy market.[73] In March 2011 its Retail Market Review (later referred to as RMR) found a mixed picture. There was evidence of the removal of what it regarded as large unjustified price differences between some payment types, there was one new entrant in the market and a small rise in the market share of small suppliers. [74] But there was no change across much of the market. In several respects it perceived a deterioration, including:

- "complex pricing structures are contributing to lower customer engagement"
- "an increase in the number of tariffs available may also be contributing to lower customer engagement"
- "an increase in the number of passive consumers and fall in the number of active consumers" (p. 4)
- evidence that energy prices have tended to rise in response to wholesale cost increases more quickly than they fall with decreases"

Ofgem's analysis seems to have centred on the following argument about customer engagement.

> "3.4. We regard consumer activity as a key driver of competition among suppliers and to stimulate new entry. The greater the number of engaged consumers, the greater the competitive pressure on suppliers to make efforts to retain them. We have found a number of market features that lower consumer engagement, the most significant being complex tariff information and the prevalence of sticky customers." (p. 46)

Ofgem concluded that "further radical actions are required". To facilitate new entry it proposed steps to increase liquidity in the wholesale market. It also proposed to strengthen the Probe remedies and to improve reporting transparency. But in its most significant innovation, Ofgem proposed measures "to make it far easier for domestic customers to compare prices and get a better deal".

These measures focused particularly on what Ofgem called standard evergreen tariffs, on which most residential customers were (and still are) supplied. Standard tariffs comprise a monthly or quarterly fixed charge (commonly called a standing charge, or in US a customer charge) plus a unit or usage rate (in pence per kWh) applied to the amount of energy consumed. [75] This tariff is variable in that it can be modified at the supplier's discretion, subject to a minimum period of notice. Evergreen means that the tariff is for a period of indefinite length: there is no specified termination date as there is for a fixed-price fixed-term contract.

> "3.15. We intend to address confusion in the domestic market by a proposal to restrict the number of tariffs for standard evergreen products from each supplier to only one per payment method. We

[73] Ofgem press release 20 November 2010.
[74] Ofgem, *The Retail Market Review – Findings and initial proposals*, 34/11, 21 March 2011.
[75] Economists tend to see the fixed or customer charge as related to costs that are largely independent of usage, such as transmission and distribution charges, environmental and social charges, and billing and collection costs. After the emergence of retail competition in the UK, most large suppliers responded to a significant customer demand by offering the option of a standard tariff with zero standing charge. The unit rate for such tariffs was typically higher for the first block of units consumed and lower for subsequent units: what is called a declining block tariff in the US.

> also propose to standardise the format of these tariffs across suppliers, with suppliers allowed to compete on a single 'per unit' price. Consumers would then be able to tell at a glance whether they can save money either by switching supplier or by moving to a new deal. This would be a major reform impacting the 75% of customers currently on standard evergreen products." (p. 48)

Ofgem's logic was that customers would then have only one number to compare among suppliers, namely the unit rate. This would simplify the market and encourage customer engagement. It was, incidentally, a policy that Ofgem had considered and rejected just two years earlier.[76]

3.2 The nature of competition

In order to appraise Ofgem's RMR and subsequent events, it will be helpful to understand in general terms Ofgem's economic analysis in the Probe and RMR, which reflects the following view of competition: Competition requires a homogenous product and well informed customers. Energy is a homogenous product but many customers are not well informed and able to compare prices, because of the number and complexity of tariffs. In consequence there is market failure such that a) those customers fail to avail themselves of the lowest price offers in the market, hence b) competitive pressures on suppliers are less than they otherwise would (or should) be, hence c) prices in the market and supplier profits are higher than the competitive level. The remedy is to simplify tariffs, so that a) more customers will engage in the market and select lower prices and b) competitive pressures on suppliers will increase, thereby lowering prices and profits to the competitive level.

Ofgem cites no economic analysis or empirical evidence in support of its claim that number and complexity of tariffs is a major determinant of customer engagement and switching. All the empirical evidence (including as mentioned above and below) is to the contrary: switching is heavily influenced by the size of prospective gains. Hence the suggestion that the increase in the number of passive customers and fall in number of active customers after 2008 was a consequence of the increased number of tariffs available is implausible. Ofgem chooses not to acknowledge the possibility that its own non-discrimination policy caused both the reduction in active customers (as fewer attractive offers were now available) and the increased number of tariffs available (as suppliers responded by developing other forms of competition).

If this were simply a matter of testing a hypothesis about economic theory it would be interesting to observe the result. In fact, however, Ofgem's over-simplified and incorrect economic analysis leads it to ignore some serious adverse consequences of its policy.

A more appropriate and realistic approach sees competition as a rivalrous discovery process. This approach has been developed primarily by Austrian economists and has been repeatedly endorsed by the Competition Commission (and by the first Chair of the new CMA). Consider some examples of how this applies to the residential energy sector.

Suppliers seek to discover those customers that are least expensive to serve – for example, direct debit customers, prompt pay customers those who accept online billing - and compete for their custom by offering them discounts. Suppliers also seek to discover product variations that will appeal to certain customers more than the standard tariff – for example, tariffs without a monthly

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[76] Ofgem, *Energy Supply Probe - proposed retail market remedies*, Ref 41/09 15 April 2009, paras 3.14 – 3.44, pp 15-17

standing charge or with a uniform monthly bill throughout the year. Rivalry between suppliers tends to drive such discounts and tariff prices to reflect costs and cost savings to suppliers.

Ofgem's analysis and its simple tariffs policy simply ignore these two aspects of competition. The loss of discounts that reflect cost savings to suppliers, and the loss of product variations that better reflect the preferences of some customers, play no part in Ofgem's analysis.

Seeing competition as a rivalrous discovery process does not assume that customers are or need to be well informed for competition to be effective. Rather, the task of suppliers is not only to discover what customers want, but also to discover how to reveal this to customers and to persuade them to engage sufficiently to purchase the product offered. Suppliers have long discovered that the most effective way to do this is generally to make a range of different yet attractive offers on price, which might include the offer of discounts. To the outside observer and to Ofgem these might seem unduly complex, but suppliers choose them because they are more effective at encouraging customers to engage than the remedies that Ofgem proposes.

The next few sections illustrate this analysis in more detail with reference to the sequence of policies proposed by Ofgem and others over the last five years or so.

3.3 Ofgem's Procrustean Bed

Following up the ideas foreshadowed in the Probe and set out in its March 2011 RMR, Ofgem announced in December 2011 that it would require suppliers to provide a price comparison guide and a Tariff Information Label. There were also proposals to improve bills, annual statements, contract renewal statements and price increase notifications. But the central proposal was tariff simplification. Ofgem explained that "Customers have told us they would be far more likely to engage in the market if it is easier to make comparisons between tariffs. In our quantitative research, [about 75 per cent] of respondents stated that they would be more likely to switch if a common standing charge and a price comparison metric were introduced".[77] Accordingly, Ofgem's central proposal was that

- suppliers would offer only one standard tariff per payment method;
- Ofgem would set a standardised (uniform) fixed [standing] charge for all standard tariffs;
- suppliers would then compete on a single unit rate for each standard tariff.

In my response to Ofgem's consultation I referred to this proposal as Ofgem's Procrustean Bed.[78] Those suppliers whose monthly fixed charge was above Ofgem's standard fixed charge would have it reduced, those whose fixed charge was below this level would have it increased. All suppliers' tariffs would thus be cut or stretched to fit this Procrustean Bed. The following are some of the questions and answers that I proposed, and criticisms that I levied against this proposal and the thinking behind it.

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[77] Ofgem, *The Retail Market Review – Domestic Proposals*, 166/11, 1 December 2011, p. 10 para 2.8. The actual proportions were 76% of Economy 7 respondents and 74% of non-Economy 7 respondents. Economy 7 is a tariff that has a lower unit rate for 7 hours night consumption than it does for day consumption. About 3 million electricity customers (about 10% of the market) have meters that measure consumption in two different time periods of the day.

[78] Stephen Littlechild, *Ofgem's Procrustean Bed: a response to Ofgem's Consultation on its Retail Market Domestic Proposals*, 23 January 2012. This can be found on Ofgem's website as Response 1, RMR domestic informal responses, but the names of domestic respondents have been blacked out. A summary and slight extension of my response is in *Oxera Agenda*, February 2012, pp 1-5.

Is it true that "sticky" customers – those who tend not to change supplier – get higher prices? Yes, but that is true in any market: customers shop around precisely to get better terms than they would otherwise pay. Ofgem's data suggest the difference was in the range 10 – 15%, which does not seem large compared to the price differences observable for other products in other markets. In fact the difference seems to have been at about this level since the retail market was first opened.[79] This is surely a quite remarkable achievement. Retail competition seems to have ensured that even those customers who made no attempt to change supplier received a price that was within 10 to 15% of the very best price in the market (for the same payment type in the same area).

Was Ofgem's customer research reliable? It had significant limitations.

> "What are we to make of a finding that about three quarters of respondents say they would be more likely to switch if a price information guide were made available - *when such guides are widely available and used in the market already*?
>
> Should we place any weight on research that finds that only 6% of respondents would probably choose a variable tariff [rather than a fixed price] – *when in reality about 75% of customers have actually chosen such a tariff*?
>
> The reality is, that the quantitative research provides no basis for believing that consumers will be far more likely to engage effectively in the market if comparisons are made easier by requiring all suppliers to set a common standing charge." [80]

To impose uniform standing charges would be inconsistent with the variety of terms associated with other products with which customers deal on an everyday basis, for example in supermarkets. Uniformity would be inconsistent with the flexibility, innovation and personal tailoring of terms associated with the proposed introduction of smart metering, which (according to the Government) promises "new products and services in a vibrant market".

Uniform standing charges would also have a number of significant disadvantages. For example, they would preclude tariffs with zero standing charge that are valued by important groups of customers, especially old age pensioners. They would increase the costs and risks to suppliers, who would be unable to modify a significant component of their revenue in response to changing circumstances. Complying with and enforcing the policy would increase regulatory costs, in turn paid for by customers. (This is no trivial matter when the new set of rules is embodied in 145 additional pages in each supplier's licence, for each fuel.) Setting energy prices would once more become the responsibility of the regulator, hence there would be more lobbying by suppliers and customer groups. Energy pricing would once again become a political decision rather than the outcome of a competitive market.

3.4 Simpler tariffs

On 26 October 2012 Ofgem changed tack, having "listened to concerns" and recognised some "practical difficulties", though it did not explain what these concerns and difficulties were.[81] It

[79] "6.4 … Median savings for standard credit and direct debit customers who switch away from BGT are 14% and 9% respectively. … 6. 13 The median discounts available on the incumbent supplier range from 5-13% for the standard credit tariff, and 6-14% for direct debit…. 6.14 … Competitors have tended to reduce prices and it is possible to get a discount of 10-15% on the former incumbent suppliers in most areas." Ofgem, *Review of domestic gas and electricity competition and supply price regulation, Evidence and Initial Proposals*, November 2001.

[80] Littlechild, "Ofgem's Procrustean Bed" *op. cit.* p 3.

abandoned its proposal to set uniform standing charges. However, it kept its other proposals (including a price comparison guide and tariff information label) and introduced additional restrictions to simplify the energy market.

It now proposed that each supplier should be limited to a maximum of 4 tariffs per fuel per payment method.[82] All tariffs had to have a simple two-part structure, ie. a standing charge and a unit rate. The standing charge could be zero, but the unit rate could no longer vary with the level of consumption (i.e. declining block tariffs were prohibited). Discounts were only allowed if expressed in pounds, not as percentages. Customers on tariffs no longer available to prospective customers ("dead tariffs") were required to be moved to that supplier's cheapest live or open tariff.

With some modifications (e.g. to prohibit all but two kinds of discount) these tariff restrictions generally came into effect on 1 January 2014, although most suppliers had adjusted their range of tariffs earlier. There were predictable consequences. Suppliers naturally chose to keep their most popular and profitable tariff types and phase out their minority preference tariffs. They have substantially withdrawn green tariffs.

Supplier E.On previously had a StayWarm tariff that offered customers over 60 years of age a fixed monthly bill regardless of how much energy the customer used (though the bill could be adjusted on a forward-looking basis depending on actual usage). This tariff was popular with customers, and highlighted by Ofgem in 2001 as one of a small number of major initiatives by fuel companies to address the needs of the fuel poor.[83] This tariff has now been withdrawn. The popular two-rate tariffs with zero standing charge are effectively prohibited because they are not viable with a single unit rate. (They are uneconomic for suppliers at low usage and too expensive for customers at high usage.) They too have had to be withdrawn.

Supplier SSE earlier introduced a new tariff that, for several months, price comparison websites deemed "the best offer in the market". That tariff was prohibited because the discount was greater in the first year than in the second. Introductory and "cash-back" discounts that some suppliers have used are now banned. Prompt payment and all but two other types of discounts are now prohibited too.

Some supermarkets and other organisations have previously competed in the retail energy market by offering products on a "white label" basis, whereby an energy supplier provides the product and backup service under the supermarket's name. Previously these white label products could be tailored to the supermarket's specification. Now, they will count against the supplier's limit of four products, hence the supermarket can only offer the same product as the supplier itself offers. Some supermarkets have considered entering the market on their own account, in competition with energy suppliers, instead of using a white label. Until recently, they could have competed by offering discounts on grocery bills. Now, they are prohibited from doing that.

In future, a supplier can only introduce a new product if it withdraws one of its four allowed tariffs. But existing tariffs will be tried and tested, whereas new tariffs are necessarily more risky and liable to have a low take-up in early years. This will surely discourage innovation, and has

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[81] Ofgem, *The Retail Market Review – Updated domestic proposals*, Consultation, Ref 135/12, 26 October 2012, p. 9. This was also one week after the Prime Minister made his own impromptu proposal, discussed below.

[82] The two fuels are natural gas and electric power. The three payment methods, as noted earlier, are direct debit to a bank account, cash or cheque on receipt of bill, and prepayment via a top-up card.

[83] Ofgem report to Labour Energy Minister Brian Wilson about the Social Action Plan, 14 September 2001.

already done so. As of summer 2014 the Big 6 suppliers have limited themselves to a standard variable tariff and two or three fixed-price tariffs for different periods ahead.

The whole policy of tariff simplification brings to mind Hayek's comment about the absurdity of trying to create perfect competition by compulsory standardization.[84] As with the non-discrimination policy, it is to be hoped that the CMA investigation will examine whether the outcomes can really be described as "fairer", and better for vulnerable customers, than the previous tariffs.[85]

3.5 Adjudicating on disputes and derogations

Given the extent, detail and severity of Ofgem's restrictions, one would expect disputes about whether particular products are compliant with the rules. Also, Ofgem provided for the possibility of derogations in exceptional cases. Not surprisingly, disputes and applications for derogations have been mounting. Ofgem has already rejected an application by small supplier Utilita to continue to offer a two-rate tariff that its 100,000 prepayment meter customers preferred.[86]

Consider three more examples. Should a wind energy supplier be allowed to offer a discount to its customers in the neighbourhood of a windfarm if the wind output is greater than expected? Should suppliers and price comparison websites be allowed to make cashback offers to customers who switch supplier? Should suppliers be allowed to pay customers interest on bill overpayments?

In all these cases, common sense and effective competition say Yes. But Ofgem rules say No. Ofgem has created the problematic situation where it is constantly required to judge which interpretations, exceptions and innovations are in consumers' interests. How has it dealt with them so far?

Ofgem has granted Good Energy, the wind energy supplier, temporary (two year) derogations at two sites, enabling it to give a discount of up to £50 per year to local residents. This is a sensible decision, but with an odd first justification: the impact on consumers as a whole would be

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[84] "The belief in the advantages of perfect competition frequently leads enthusiasts even to argue that a more advantageous use of resources would be achieved if the existing variety of products were reduced by compulsory standardization. …[They] believe that the variety of people's tastes should be disregarded and the constant experimentation with improvements should be suppressed in order to obtain the advantages of competition. It would clearly not be an improvement to build all houses exactly alike in order to create a perfect market for houses, and the same is true of most other fields…." FA Hayek, "The Meaning of Competition", Princeton University, May 20, 1946, reprinted in Hayek, *Individualism and Economic Order*, London: Routledge and Kegan Paul, 1948.

[85] Recent feedback published by Ofgem already casts doubt on this. "Those who think there is too much choice tend to have recent experience of comparing and switching; be internet users; come from higher social grades and pay by direct debit. Those who think there is too little choice are more disadvantaged and more likely to be on prepayment meters or other prepayment schemes." *Ofgem Retail Market Review Baseline Survey* © TNS 2014.

[86] "Pre-payment meter customers hate a standing charge. … If they use nothing they pay nothing – our customers love that….Now, Utilita has to introduce a standard charge and we will have to tell customers. We applied for a derogation and Ofgem turned it down. We have to get into a complicated conversation [with customers] about prices, so we have gone from a single tariff that was clearly acceptable to 100,000 customers who have all been spoken to and all had it explained. Ofgem did not even consider this. They know nothing about pre-payment customers and produced a set of rules that are totally inapplicable." Interview with Utilita CEO Bill Bullen, *New Power*, Issue 65, July 2014, pp 30-33.

minimal, given the limited number of eligible customers. By implication, discounts that benefit a larger number of customers would be prohibited.[87]

Large supplier SSE made cashback offers and was told by Ofgem to stop. Now a small supplier First Utility and a price comparison website Topcashback are making cashback offers. Ofgem has reportedly said that it is gathering evidence and intends to consult, so it would not be in consumers' best interest to take formal action now. Can one hope that such discounts will henceforth be allowed?

New supplier Ovo offers customers a 3 per cent discount on payments made in advance. A rival small supplier has complained to Ofgem that this puts customers at risk and violates the obligation to offer a cash payment option. The issue is presently under discussion.[88] Ovo is a vigorous new competitor in the market. It not only offers lower prices, but prides itself on good quality of service. This discount is an imaginative way of rewarding and reassuring those customers who are wary of direct debit or paying in advance. The policy also means that Ovo's customers pay up front so that Ovo does not have to borrow to buy energy, and the reduced cost is passed on to customers in the form of lower prices. This is precisely the kind of beneficial innovation that competition can provide. Surely Ofgem should be allowing and encouraging it, not preventing it?

3.6 Will simpler tariffs motivate customers?

How can such a repressive regulatory policy promote competition and be in the interests of customers? Ofgem's argument noted earlier is that tariff simplification will encourage customers to shop around and find a better deal, and that this increased pressure will force suppliers to offer lower prices.

Whether customers will actually perceive the energy market as simple is debateable. In addition to the 6 large suppliers there are now 11 smaller suppliers offering both fuels, 4 offering gas only and 2 offering electricity only.[89] Each is allowed to offer 4 tariffs per fuel x 3 payment methods. That makes 480 tariffs in each region (so with 14 regions that makes nearly 7000 tariffs nationally). And ministers have recently suggested that the Big 6 suppliers need to be the Big 60 or even the Big 60,000 …..

Whether customers will actually prefer simple tariffs when they understand the implications is questionable. A recent survey of rail customers found that the majority preferred a more complicated system with some low price options to a simplified system with fewer low cost

[87] The second justification was that "any potential detrimental impacts on consumers would likely be outweighed by the social and environmental benefits associated with such a scheme that has local/community benefits". The possibility that the scheme would have beneficial impacts on consumers does not seem to have been considered. Ofgem, *Good Energy Derogation Letters*, Delabole 15 January 2014, Hampole, 14 May 2014.

[88] Tim Webb, "Ovo Energy accused in early payment row", *The Times*, 14 July 2014.

[89] Ofgem, OFT, CMA, *State of the Market Assessment*, 27 March 2014, Fig 38, p 78.

options.[90] Ofgem's own consultants reported that customers did not wish minority green tariff options to be removed.[91]

A subsequent YouGov Cambridge survey explored views on energy tariffs. 84% of respondents said that they would support the energy regulator making energy companies simplify their tariffs, and only 2% were opposed.[92] But only half (51%) wanted a limit on the number of different tariffs that a supplier can offer. Less than a fifth (19%) wanted to stop discounts expressed in percentages rather than pounds. Only 9% thought supermarkets should be stopped from offering discounts on grocery purchases to customers who buy energy from them. Only 7% thought existing suppliers should be stopped from offering a lower price to match a competitor. Least popular of all (3%) was stopping discounts for prompt payment of bills which is, astonishingly, a prohibition that Ofgem has imposed. When those who supported simpler tariffs were asked whether they would still support them if it meant that tariffs might be slightly higher or if fewer discounts were available, the picture changed significantly. The support for simpler tariffs fell from 84% to 26%. The proportion opposing simpler tariffs increased dramatically, from 2% to 39%. Having considered the possible adverse consequences, a greater proportion of respondents opposed simple tariffs than supported them.

What actually motivates customers to consider switching suppliers? Ofgem asserts that complexity hinders switching. But research by Ipsos Mori for Ofgem reported that 77% of non-switchers said they were happy with their current supplier, 22% said switching was a hassle, and 20% said there wasn't much difference between the suppliers to make switching worthwhile.[93] Various other reasons were given, but none of these non-switchers is reported as saying that complexity of tariffs was a reason for not switching.

Yet Ofgem focuses on tariff complexity to the exclusion of other considerations. It says "Ofgem is not looking at consumers' incentive to engage driven by sensitivity to prices and to brand loyalty". [94] But why not? Ofgem's own earlier research had found that "the largest single factor affecting a supplier's customer churn rate is its relative price, and … the level of marketing expenditure is very similar to price in its effect on a supplier's churn rate".[95] Other research has confirmed this.[96]

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[90] Respondents were asked whether they would prefer the current system, with lots of tickets and prices including some very low cost options on restricted terms, or a simplified system, with a smaller range of tickets and prices, fewer low cost options and less restricted terms. On average across a range of actual and potential customer types and a range of routes, about 55% of customers preferred the current system, about 38% preferred the simplified system and about 7% could not decide. Accent, *Survey of Rail Customers*, August 2013. I am grateful to Rob Sheldon for sight of this study.

[91] "Just 10% of consumers, vulnerable or not, would select green tariffs for themselves, though a further 47% of all consumers and 44% of vulnerable consumers would like to see them made generally available." Ipsos Mori, *Consumer Reactions to varying tariff comparability*, Quantitative Research conducted for Ofgem, 18 October 2011, p 27.

[92] YouGov-Cambridge Online survey of 1942 adults undertaken 29-30 January 2014, figures weighted and representative of all GB adults. The data herein are taken from Stephen Littlechild, "Sorry Ofgem: why simpler tariffs are not in consumers' interests", CityAM, April 3, 2014. Results of the survey were presented at YouGov-Cambridge Survey: Energy, Politics and the Consumer, London, 3 April 2014.

[93] Ipsos Mori, *Customer Engagement with the Energy Market – Tracking Survey*, Report prepared for Ofgem, 28 January 2011, p 20.

[94] Ofgem, *Retail Market Review (RMR) – Updated domestic proposals, Consultation*, Ref 135/12, 26 October 2012, para 1.32, p 17.

[95] Ofgem, *Energy Supply Probe – Initial Findings Report*, 6 October 2008, para 4.14 pp 49-50.

[96] Giulietti M, C Waddams Price and M Waterson, "Consumer choice and competition policy: a study of UK energy markets", *The Economic Journal*, 115 (506), 2005, 949-968; Flores M and C Waddams Price, "Consumer behaviour in the UK retail electricity market", CCP Working Paper 13-10, October 2013.

Ofgem's earlier research also found that marketing expenditure has a similar effect to price. This too is plausible, hence the expenditure by price comparison websites that enable switching (there are nearly a dozen such websites in the UK) as well as by energy suppliers themselves. It is common to see advertisements such as "Compare your energy bills and save up to £294!" or "Free wine when you switch". Hence too we find eye-catching offers such as "British Gas plans to offer 'free electricity' on Saturdays", an offer that would not be allowed under present regulations unless a smart meter were involved.

Overseas evidence casts similar doubt on the claim that simple tariffs will promote switching. The Australian Energy Regulator (AER) describes a similar range of products on offer as used to be available in the UK, and comments "The variety of discounts and non-price inducements makes direct price comparisons difficult. Further, the transparency of price offerings varies."[97] Despite this, from 2008-09 to 2012-13 the small customer annual switching rate increased from 16% to 23% in South Australia, from 11% to 26% in NSW, and from 27% to 31% in Victoria.[98] Furthermore, the state where electricity suppliers have the highest diversity in retail product offers is Victoria (*Ibid* Table 5.4), which has the highest customer switching rate.

Ofgem's policy is thus inconsistent with empirical evidence. It assumes that regulators know more about what motivates customers than the suppliers and price comparison switching sites that need to discover and provide what customers want if they are to survive in the market. It seems to imply that supermarkets and their suppliers, which by Ofgem's logic surely confuse customers with their thousands of products and product variations, have got it wrong all this time.

[97] *State of the Energy Market 2013*, Australian Energy Regulator (AER), 20 December 2013, ch 5 Retail Energy Markets, p 133.

[98] Fig 5.3 p 128. The switching rate fell in Queensland, from 20% in 2009-10 to 13% in 2012-13, because of regulation. "This fall coincided with a reduction in marketing effort by energy regulators in Queensland, reflecting concerns about the process for setting regulated electricity prices." These percentages are not directly comparable with those in GB because the Australian figures are for "small customers", which includes small businesses as well as residential. In GB, small business switching rates are a few percentage points higher than residential switching rates. It would be helpful to calculate the corresponding small customer switching rate in GB, but it is undoubtedly lower at present than in the three states cited.

4. Other recent proposals

Ofgem's publicly expressed reservations about the competitiveness of the retail market, and its willingness to impose a wide range of significant restrictions on what energy suppliers can offer, seem to have stimulated an unconstrained open season on suggestions for policy. None of this remarkable number and variety of additional suggestions finds Ofgem's own actions adequate to address the problems perceived. The following are some of the main proposals advanced.

4.1 Putting customers on the lowest tariff

During question time in Parliament on 17 October 2012, the Prime Minister suddenly announced that energy suppliers would be required to put customers on the lowest tariff. This proposal, which took the Department of Energy and Climate Change (DECC) and Ofgem by surprise, was acclaimed in some of the news media and by some suppliers.[99] In the May 2013 County Council elections, a leaflet put through my door claimed that "Conservatives in Government have forced energy companies to put customers on the lowest tariff". Actually they haven't, and it begs the question of why the Government rather than the energy regulator was doing this. But what does the commitment actually mean?

If it means the lowest tariff offered by any supplier in the market, is it really plausible to oblige suppliers to transfer customers to their rivals? Even if it means the lowest tariff offered by that same supplier, would that be a good thing regardless of the conditions of that lowest tariff? For example, the SSE tariff cited above as "the best offer in the market" had a £50 exit charge for leaving within two years. Would customers on a standard tariff without an exit charge appreciate being transferred to such a tariff? Would those customers presently receiving paper billing statements appreciate being transferred to an online-only tariff even if it had a lower charge?

If the commitment means the lowest tariff offered by the same supplier, the policy would have an additional little-acknowledged downside: it could discourage a supplier from introducing that lowest tariff in the first place. A price cut to attract new customers might be an attractive commercial prospect, but a price cut required to be applied to all a supplier's existing customers might simply lose revenue.[100] A policy intended to give a better deal to customers could thereby reduce the number and variety of new offers available, weaken competition and leave customers worse off.

In the event, practicalities prevailed. The policy was watered down to oblige suppliers to provide Cheapest Tariff Messaging (CTM) that provides consumers with personalised information on how much they could save by switching tariffs with their current supplier. Even that begins to look complicated.[101]

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[99] "David Cameron stands by 'lowest' energy tariff vow", BBC News, 18 October 2012. This went further than what had been discussed and agreed earlier. "The Government and energy suppliers have agreed in principle to ensure consumers know if their supplier has cheaper tariffs. Suppliers have agreed in principle to signpost consumers to cheaper deals information this winter, and we intend that by next year more bespoke information will be displayed on the bill itself." *Huhne: More teeth for Ofgem, more rights for energy consumers*, DECC announcement, 20 September 2011. "In April 2012, the Government reached a further voluntary agreement with the six largest energy suppliers for them to provide an annual communication to all customers helping them to identify what the best tariff options are for them and how to get them." Consumer Tariffs Amendments (powers a-e), Impact Assessment IA No: DECC0126, 8 May 2013, para 6.

[100] As pointed out by Ofgem in June 1999, as noted in section 2.3 above.

[101] "The 'narrow' CTM presents customers with the savings that they could achieve by switching to the cheapest tariff from their supplier that is similar to the one they are currently on. The 'wide' CTM presents customers with

4.2 A national unit price

In December 2012 the consumer magazine Which? now entered the fray.[102] It said that Ofgem's proposals did not go far enough. Each supplier should be allowed to charge only one unit price, like petrol prices on a garage forecourt (US: like gas prices at a gas station), and with no fixed charge.

Would this policy have merit? As noted above, a small proportion of customers do indeed prefer a tariff with no monthly fixed charge. Until Ofgem prevented this, it has always been possible for suppliers to cover their costs by a two-rate tariff, with a higher unit rate for the first block of units and a lower rate for subsequent units. Which?'s proposal would explicitly prohibit this. The consequence would be that all suppliers would be forced to cross-subsidise small users at the expense of large users. In turn, this would incentivise them to minimise the number of small users they had to serve. Since there would be no way for suppliers to tailor products to the needs and preferences of different customers, one would expect less engagement by customers rather than more.

Ofgem rejected the Which? proposal, commenting that "unless they intend to prohibit discounts for payment method, dual fuel and paperless billing, their own proposals will be more complex than they suggest".[103]

In some versions of its proposal, Which? argued for the unit price to be a uniform national price. Leave aside that petrol companies do not in fact set petrol (gas) prices nationally, in the UK or elsewhere. What would this mean?

In a country with 14 different distribution networks with geographically different use of system charges, there would be substantial geographical cross-subsidy. It is perhaps not surprising that the first major supplier to support this approach, namely EdF, is already required to operate an internationally uniform system elsewhere,[104] though not a system without a monthly fixed charge.

Now SSE, another major supplier with growing experience of cross-subsidy, has come out in support of national prices for gas and electricity.[105]

> "It would reduce the number of steps household or small business customers need to take to find the best deal, make it easier for third parties to provide clear advice on the cheapest tariffs for different types of customer and reduce some of the complexities involved in supplying energy, especially for smaller companies. It would make it easier for suppliers to compete on price on the energy part of the bill."

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the savings that they could achieve by switching to the overall cheapest tariff from their supplier." Ofgem, *The retail market review – Implementation of simpler tariff choices and clearer information*, 27 August 2013, para 3.23, fn 33, p 34.

[102] Which? *The Imbalance of Power*, 20 December 2012

[103] Ofgem statement responding to Which? research on energy tariffs, 2 June 2013.

[104] Electricity de France (EdF) has acknowledged the need for a mechanism to carry out all this redistribution. EdF has experience of a massive cross-subsidy mechanism insofar as it is required to set a uniform price of electricity throughout France and the former French empire (in countries such as Guadeloupe). EdF 15 June 2013.

[105] "Asking the right questions", Alistair Phillips-Davies, CEO, SSE, 17 July 2014.

There are of course equity issues associated with requiring customers in some (low-cost) areas to pay the costs incurred to supply customers in other (high-cost) areas. And a national price would prevent suppliers from appealing to customers by charging lower prices in regions where incomes were lower or unemployment higher. So it is not clear that the outcome would be "fairer".

There are also clear economic disadvantages, which SSE does not mention, to be set against the first three of its benefits. The arrangement would increase the costs to customers as a result of the costs of operating the cross-subsidy mechanism – as in France, where the cross-subsidy is financed by a Public Service Charge on customers. The arrangement would reduce efficiency nationally as a result of removing locational signals – in effect, it would lead consumers to ignore the fact that electricity is more expensive to produce in some areas than others. And it would increase the likelihood of over-investment in local electricity distribution systems because the additional cost will be spread over all customers rather than paid for by the local customers who have an increasingly important role in advising on network investment business plans.

The remaining claimed benefit of national pricing is the most disingenuous. Far from making it easier for suppliers to compete, it would make it easier for them not to compete. As indicated above and explained more fully below, Ofgem's various required restrictions to enforce non-discrimination, simplicity and transparency, implemented remarkably enthusiastically by the largest suppliers, have increasingly created the most favourable conditions possible for coordinated conduct. And retail profit margins have risen. It is disappointing, but not surprising, to find a major supplier hoping that "simplicity and transparency are at the heart of any recommendations it [the CMA] makes". National uniform pricing would be the final nail in the coffin of retail competition.

4.3 Freezing energy prices

The next proposal, by Ed Milliband, Leader of the Opposition Labour party and himself a former Secretary of State for Energy, was for an energy price freeze. In September 2013 he said that, if elected in 2015, his party would freeze residential energy prices for 20 months "to ensure that prices do not rise in the time it takes to put a new system in place". This was needed "to rebuild trust in the energy market". This proposal attracted considerable popular support. Other political parties have poured scorn on the proposal, claiming that it would encourage suppliers to put up prices in advance, and discourage companies from investing in new capacity.

In some circumstances, temporary price caps seem defensible. I have referred above to the transitional (two-year) price cap put in place in 1998, when the GB residential market was opened to competition. (This was while I was electricity regulator at Offer.) The cap replaced the previous retail price controls which were of a cost-pass-through type. It was a novel situation: there was no previous experience anywhere of retail competition for residential customers, and the cap provided a temporary assurance to customers at a time when it was uncertain whether competition would develop at all and whether customers would be willing to change supplier even if better offers were available. It also gave a corresponding breathing space to the regulator.

However, in general price controls distort markets and reduce or distort competition. They affect different suppliers differentially, and can undermine existing offers in the market. They increase uncertainty about future regulation. They encourage the generally fallacious idea that regulation is better for customers than the competitive market. They are generally very difficult to remove.

(Ofgem deserves credit for removing the residential price cap in 2002, against considerable political and public opposition.) In general, then, price freezes are misguided and harmful.

4.4 A windfall tax

The next proposal, from former Conservative Prime Minister Sir John Major (see newspaper reports on 22 October 2013), was for a windfall tax on energy suppliers. This too received some popular support, but the economic logic is difficult to follow. The Labour Government's windfall tax on the privatised utilities in 1997 was designed to share with taxpayers part of the substantial increase in share prices that shareholders had enjoyed since privatisation. This increase derived not from excessive profits but primarily from the ability to "gear up" the privatised businesses and borrow more equity, at a lower cost of capital, than had been anticipated at the time of flotation.

In contrast, there has been no such source of unanticipated gain in recent years, nor any claim by the regulator that energy companies have been making excess profits, although a debate has subsequently developed as profits have increased over time. In consequence, the threat of a windfall tax is likely to jeopardise needed investment in new generation capacity, and the effect of the increased risk on cost of capital is more likely to increase than to reduce energy prices for customers.

4.5 Reallocating environmental costs

In December 2013, under pressure on energy prices and policies, the Coalition Government announced a range of measures to reduce household energy bills by an average £50 a year. The measures include reducing or deferring the environmental obligations on suppliers, getting distribution companies to defer increases in their network charges, and meeting some costs out of taxation rather than out of energy prices.[106]

Environmental costs have been rising significantly over time, the precise ways in which they have been charged to customers are unclear, and the distributional implications are also unclear albeit increasingly significant.[107] The Government's recent measures increase uncertainty about suppliers' costs, and there has been controversy over the fact that some suppliers have passed these cost reductions on to customers on fixed price contracts whereas other suppliers have not. The implications for competition and new entry have been discussed above.

4.6 A state-run price comparison website

In February 2014, reportedly the latest political wheeze from the Prime Minister's office (Number 10 Downing Street) was a state-run price comparison website.[108]

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[106] *Government action to help hardworking people with energy bills*, DECC Press release, 2 December 2013.

[107] Chawla, M and M G Pollitt, "Energy-efficiency and environmental policies & income supplements in the UK: Their evolution and distributional impact in relation to domestic energy bills", EPRG Working Paper 1227, Cambridge Working Paper in Economics 1256, December 2012.

[108] "Meerkats and an annoying opera singer, beware — David Cameron is coming for you. No. 10 is drawing up plans for a state-run price comparison website. … [Present] sites, which are highly profitable, charge a commission, meaning that consumers do not receive the full benefit of switching suppliers. … There have also been allegations that some insurance comparison sites 'game' the market, meaning customers do not always get the best deal. … [According to a leaked paper from No. 10] 'We [government] (or a trusted third party) could provide one, trusted source of information on prices and service levels across all markets: energy, telecoms, broadband and financial services….Because it would be non-profit (but self-funding) we could encourage the industry to advertise a link to

If it were true that Government (or a trusted third party) could run a price comparison website with better service and at lower cost than the private sector, all to the benefit of customers, then presumably it could do so for other businesses too. In reality, as the nationalised industries demonstrated, this is a delusion. To be successful, price comparison websites have not merely to provide full and accurate information provided by companies, they also have to attract the attention of customers who may not know or care whether there are better deals to be had. Meerkats and an opera singer, and other devices used by successful price comparison sites (such as Churchill the bulldog), may be irrelevant and costly frippery from the perspective of well-informed and engaged customers in a perfectly competitive market. In the real world, such devices serve to attract the attention of otherwise uninterested consumers. Do the Government (or trusted third parties) know more about attracting the attention of uninterested consumers and providing services that they want than businesses that can only survive by succeeding in that quest?

There are additional disadvantages of Government and regulatory involvement in price comparison websites. There will be lobbying by those suppliers who stand to gain differentially from lower/zero charges for use of those sites. One small supplier has already made its pitch. This means further distortion of the competitive market, with the Government and/or regulator handing out favours.

Such involvement will also be used to further the ends of the Government or regulatory body concerned. This is already happening. In March 2013 Ofgem took over (from Consumer Focus) responsibility for the running of the code of practice for price comparison websites. It has now announced that "we are reviewing it to ensure that its objectives are in line with our reforms for a simpler, clearer, fairer energy market".[109] Not only have the products available in the market been restricted to conform with Ofgem's policy, now the availability of information about these products is to also be tailored to the same end. Given the consequences of Ofgem's policy to date, this is an unfortunate development.

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the switching site in their customer communication, thereby increasing customer engagement on switching. The site could potentially save consumers money as their switches would avoid commission fees.' One supporter of the plan said: 'This is about really turbo-charging switching so that consumers get a better deal.'" "Cameron to take on meerkats at their own game", *The Times*, 1 February 2014.

[109] Ofgem, *Statement on energy price comparison sites and commission*, 23 January 2014.

5. From Ofgem to the Competition and Markets Authority

5.1 Competition assessment framework

In 2013 the Government announced that Ofgem would work with the Office of Fair Trading (OFT) and the Competition and Markets Authority (CMA) to carry out "an assessment of how well competition in the markets for gas and electricity is serving the interests of households and small firms in Great Britain".[110] In December 2013 the three organisations jointly set out a *Competition Assessment Framework*.[111] It was said to follow a standard typology, based on Competition Commission (CC) *Guidelines*. [112] I have discussed this assessment framework at length elsewhere.[113] Of particular relevance to this paper is that, in a number of respects, the *Competition Assessment Framework* was evidently presented from an Ofgem perspective, and sheds light on Ofgem's thinking on the nature of competition. This is of interest for students of Ofgem, but a concern from the perspective of an independent assessment of it.

In some but not all of its market investigation reports, the CC invokes the concept of a "well-functioning market" as a benchmark against which to assess a potential Adverse Effect on Competition (AEC). In practice, the CC generally takes the well-functioning market to be the market itself without the AEC, and makes little or no further reference to this concept.

In contrast, the *Competition Assessment Framework* takes a detailed "look at some of the characteristics we would expect to see in a well-functioning energy market in the short and longer term". (para 3.6) It begins "3.8. In the short term, we consider that a well-functioning energy market would be characterised by consumers being engaged and empowered to secure good outcomes when they participate in the market."

This is less a description of how a competitive retail energy market would actually operate, than a description of what it would be nice to have. It is, literally, what the *Competition Assessment Framework* elsewhere (p 4) describes as Ofgem's "vision" of a successful energy market, that would exhibit "new entrants … innovative products … high levels of customer service, significant switching" etc. The vision is not anchored in any concept of what levels of new entry, innovation, customer service and switching it is realistic to expect a competitive market to provide. Obvious comparators would be the UK retail energy market in previous years, energy markets in other countries with and without retail competition, markets for other utility products, and markets for other products and services generally. None of these real markets is mentioned: the benchmark is simply a vision.

The opening reference in the *Competition Assessment Framework* is to "how competition should work to deliver desired outcomes". (para 3.2) This is an instrumentalist view of competition. It is not based on an understanding of how markets actually work. It is a description of how a regulatory body, subject to statutory duties and political pressures, would find it convenient for a competitive market to work, in order to "deliver desired outcomes".

[110] Ofgem, OFT and CMA, *Letter to Secretary of State for Energy*, 5 November 2013.
[111] Ofgem, OFT and CMA, *State of the market report – Assessment framework*, 19 December 2013.
[112] CC3 Revised, *Guidelines for Market Investigations: Their role, procedures, assessment and remedies*, Competition Commission, April 2013.
[113] Stephen Littlechild, "The Competition Assessment Framework for the retail energy sector: some concerns about the proposed interpretation", *European Competition Journal*, April 2014,

5.2 Meeting the needs of customers

The *Guidelines* promulgated by the CC refer to "incentives for firms to meet the … needs of customers … by improving quality or variety, or introducing new and better products". In any framework for assessing competition in the energy sector one would therefore expect to see, inter alia, indicators seeking to measure the range of products including special offers. This is in fact what Ofgem looked for and found when it reviewed gas and electricity competition back in 2001,[114] and in subsequent reviews until 2007, and in its 2008 *Probe Initial Findings*[115].

Surprisingly, the *Competition Assessment Framework* does not mention such characteristics. For example, discounts for direct debit, prompt payment, online accounts etc are no longer seen as a means of competing by offering benefits to customers and thereby encouraging them to engage in the market. At best characteristics such as dual fuel are now taken for granted. At worst other characteristics are regarded as harmful complexities that serve mainly to befuddle customers and discourage them from engaging in the market. Ofgem's policy is now to *suppress* tariff variety and to *prevent* firms from tailoring their products to the different needs of different customers. Regrettably, the *Competition Assessment Framework* endorsed by the CMA has rejected Ofgem's original policy and accepted its new one, surely without adequate time to reflect on the matter.

5.3 Weak customer response

The *Guidelines* set out several potential sources of harm. Some of these are long-familiar. The fifth such potential source of harm, which is relatively new, is "weak customer response" as a result of customers lacking information or being unable to choose.[116] The *Competition Assessment Framework* too, like the *Guidelines*, identifies weak customer response as a potential harm, and explores how it might manifest itself in the energy market.

> 4.19 Features of the market may mean that it is unnecessarily difficult for many consumers to engage effectively in the market. Ofgem's RMR found that these features may include:
> - A large number of tariffs, many of which have complex structures and discount arrangements. This makes the prospect of engaging in the market unattractive for many consumers and means it is often difficult for consumers who do engage to choose the best tariff for their circumstances. …
> 4.20 This in combination with other market features …could limit the ability of customers to find a better tariff and, in turn, limit the competitive pressure on other suppliers….

This characterisation sees engaged consumers as a prerequisite for a well-functioning market, so that effective competition is only possible once consumers are engaged. This is an unduly restricted view of competition. Rather, competition should be seen as including the process for getting consumers engaged in the market. Neglecting this latter aspect sees firms' actions in a

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114 Ofgem, *Review of domestic gas and electricity competition and supply price regulation: Evidence and Initial Proposals*, November 2001.

115 "Recent years have seen a welcome widening of the range of tariffs, payment schemes and other incentive or loyalty schemes on offer in the market, in addition to the social tariffs that suppliers are obliged to offer. We see this as a positive indication of competition at work; of suppliers responding to customer needs and tailoring their offerings accordingly." Ofgem *Probe Initial Findings*, October 2008, para 7.69.

116 "To drive effective competition customers need to be both willing and able to: access information about the various offers available in the market; assess these offers to identify the good or service that provides the best value for them; and act on this assessment by switching to purchasing the good or service from their preferred supplier." (para 296)

one-sided way, as tactics that simply increase complexity and discourage engagement, whereas the aim and effect of these actions may well be to attract customers by increasing engagement. [117]

Similarly, many of the practices that Ofgem condemns and prohibits as harmful to competition may also be seen as pro-competitive tactics seeking to stimulate customer engagement. Many of the "complex structures and discount arrangements" are designed to be attractive to, and hence attract the attention of, particular groups of customers. They are attempts to stimulate rather than depress engagement by these customers. Accumulating empirical evidence suggests that customers are more likely to engage as a result of attractive offers than as a result of less complex ones.[118] Thus, by prohibiting the arrangements proposed by firms, and imposing its own more limiting arrangements, Ofgem is actually preventing suppliers from making offers that will attract the attention of customers. It is thereby restricting rather than promoting customer engagement and effective competition.

5.4 The impact of regulation

The *Guidelines* say that regulatory requirements are structural features that may constitute a potential source of harm, and indeed have been found as such in previous market investigations. When introducing its non-discrimination conditions in 2009, Ofgem acknowledged that they could have harmful rather than beneficial effects.[119] Since then, Ofgem has not acknowledged this. Yet as documented above there is considerable accumulated and published empirical evidence that regulatory requirements have indeed had harmful effects, and that Ofgem's policy has in fact restricted and distorted competition. But the *Competition Assessment Framework* makes hardly any mention of regulation as a potential source of harm. This is Hamlet without the Prince.

5.5 Co-ordinated conduct

The *Competition Assessment Framework* says that "Our five potential sources of harm are based on those set out in the CC's standard guidelines for market investigations" (para 4.1). One of the sources in the *Guidelines* is "coordinated conduct". Yet the assessment framework omits this as a potential source of harm. Instead it substitutes "weak competition between suppliers", noting co-ordinated conduct as a possible source of this weak competition. Why the change in emphasis? Perhaps because the policies introduced by Ofgem from 2009 are a clear example of the conditions conducive to co-ordinated conduct as set out in the *Guidelines*?

For example, the *Guidelines* say

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[117] "[I]n a world of complexity, change and uncertainty, it is inevitable that consumers *are* imperfectly aware of the qualities and promise of the multitudes of goods. The need to alert consumers to *what they do not know that they do not know*, is very real. … The producer who judges more correctly what kind of dramatic advertising message will best awaken consumer interest has the more successfully served those consumers." IM Kirzner, *How Markets Work: Disequilibrium, Entrepreneurship and Discovery*, Institute of Economic Affairs, Hobart Paper No 133, June 1997, available at www.iea.org.uk", at p 55.

[118] See references above, also M Flores and C Waddams Price, "Consumer Behaviour in the British Retail Electricity Market", CCP Working Paper 13-10, October 2013.

[119] "5.70 We recognise that there are risks to the intensity of competitive activity between suppliers as a result of this measure. The impact on competition is ambiguous and made particularly uncertain by the specific characteristics of the energy supply market. … We recognise that some forms of price discrimination have in the past helped competition to develop in the domestic energy supply market." Ofgem, *Addressing Undue Discrimination – final impact assessment*, ref 73/09, 26 June 2009.

> 252 (b) Simple and relatively undifferentiated products are more easily subject to the coordinated setting of prices than situations in which each firm's offering is different from the offerings of its rivals….
> 259. Less obvious means and practices may also increase the transparency or predictability of the environment in which firms operate. These may include the adoption of rules of conduct, ethics codes, product standardization, regulatory disclosures, …price computation manuals. Such practices may sometimes be justifiable on efficiency or customer-benefit grounds, but they could also create market conditions favourable for coordination.

Ofgem's tariff simplification policy has indeed focused on limiting differentiation of products and imposing rules of conduct, product standardisation, price computation metrics and so on.

Ofgem's Probe documents clearly acknowledged the risk that the non-discrimination conditions would make coordinated conduct more viable.

> 5.62 Our Probe found no evidence that domestic energy suppliers were colluding when setting their prices. We now consider the likely impacts of our proposed licence conditions on the incentives for suppliers to collude. In some markets where a small number of firms interact repeatedly, tacit collusion (referred to as "collusion" onwards) may occur. This can allow firms to earn higher profits than if they competed more intensely.
> 5.63 One necessary condition for collusion is the ability to monitor other firms' behaviour, in order to detect whether they have deviated from a collusive outcome. The ability to monitor other firms' behaviour to detect deviation is therefore an important prerequisite for collusion.[120] .
> 5.64 Our proposed licence conditions may have implications for suppliers' ability to monitor competitors' behaviour. In particular, if licence condition B reduces the level of differential pricing between regions, it could simplify pricing strategies and may make it easier for suppliers to monitor their competitors' behaviour. The easier it is to detect deviation from collusive strategy, the less attractive deviation becomes. It is possible that the risk of collusion becoming a viable strategy may increase following the implementation of our proposed licence conditions. We will continue to monitor the market and were we to find evidence of such collusion we would be able to take action in accordance with our powers under the Competition Act 1998.[121]

Ofgem's subsequent policies have addressed all the major challenges facing a group of energy retailers that might wish to coordinate their activities to reduce competitive pressure and increase profits, but faced the problem of bringing about and policing such an agreement.[122] The initial problem is that collusion and coordination are generally illegal or anti-competitive. However, it is a different matter if the actions taken are necessary to comply with regulation.

In practice, the major challenges to firms wishing to coordinate in order to increase profits include ensuring that all existing and potential competitors participate, agreeing the steps to be taken, enforcing the actions agreed upon, and preventing cheating. Ofgem has kindly taken responsibility for all those tasks.

For example, an effective first step towards reducing competition would be to prohibit the most effective competitive tactic (here, differentially low pricing out of area). Subsequent steps would

[120] First discussed in G J Stigler, "A Theory of Oligopoly." *The Journal of Political Economy*. Vol.72, No.1, 1964: 33 – 61. [This is the footnote reference in original Ofgem document. One might add Armen Alchian, "Electrical Equipment Collusion: Why and How" in A Alchian, *Economic Forces at Work*, Indianapolis: Liberty Press, 1977: 259-272.]
[121] Ofgem, *Addressing undue discrimination: Impact assessment*, Ref 43/09, 15 April 2009.
[122] I have elsewhere documented this analysis in more detail. Stephen Littlechild, *Ofgem's Retail Choice: A Response to Ofgem's Consultation on SLC 25A*, 28 May 2012, especially Appendix 1 on coordinated effects.

be increasingly to limit the number and range of tactics by which firms can compete, notably by moving towards simpler and less differentiated tariffs with less scope for competing via discounts. Again, Ofgem has obliged.

I make no suggestion that UK suppliers have actively sought to coordinate their conduct. Ofgem has provided all this without being asked. Not surprisingly, however, the more established companies have been keen to comply with tariff simplification once proposed by Ofgem. Suppliers wishing to increase and stabilise their profit and live a quiet life could wish for no more – well, almost no more. The final steps would be to limit each supplier to a single national tariff, uniform in structure, and for the regulator to set an important part of that tariff (the monthly standing charge), leaving suppliers to coordinate the one remaining element (the unit price). Both these steps have been suggested though not yet implemented – although, as noted above, two major suppliers are now advocating a single national tariff and the Labour party now proposes to legislate to mandate it plus a standing charge set by regulation.

5.6 State of the market competition assessment

On 27 March 2014 Ofgem, the OFT and the CMA jointly presented their State of the Market Assessment.[123] At the same time, Ofgem proposed to make a market investigation reference to the CMA.[124] It confirmed this proposal on 26 June 2014.[125] It noted that "The State of the Market report identified the principal market features that may have a harmful effect on competition". These features, with Ofgem's brief explanations and my equally brief comments, are as follows.

Weak customer response. "Evidence that customer activity in the market is low, and trust is low, which is preventing the process of competition from working effectively."
Comment: There is indeed evidence that customer switching between suppliers is lower than it was until 2008, but this is a *consequence* of the reduction in competition as a result of Ofgem's non-discrimination conditions, not a *cause* of the reduction in competition. I suggest below that part of the reported low trust in suppliers can be explained by the significant increase in prices since about 2002, coupled with Ofgem's frequent questioning since 2008 of the competitiveness of this market. It is Ofgem's policy that is preventing the process of competition from working effectively.

Incumbency advantages. "Suppliers that gained a large customer base when competition was introduced continue to charge higher prices to their less active customers. This suggests competition is not working effectively for all customers."
Comment: As explained above, higher prices to less active customers is precisely what would be observed in a competitive market where suppliers have significant overhead costs.[126] It is consistent with competition working effectively, not a sign that it isn't. It has characterised this market since opening – indeed, it characterises almost every market in the world.

Possible tacit coordination. "We found no evidence of direct coordination, but there is evidence of possible tacit coordination, which can weaken competitive rivalry between companies."

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[123] *State of the Market Assessment*, Ofgem, OFT and CMA, 27 March 2014.
[124] *Consultation on a proposal to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain*, Ofgem, 27 March 2014.
[125] *Decision to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain*, Ofgem, 26 June 2014.
[126] W J Baumol *op cit.*

Comment: Some of the evidence referred to - that large retail suppliers raise prices more quickly when costs increase than they reduce prices when costs fall (the so-called rocket and feather effect) - is not compelling: there is evidence that this characterises about two thirds of all markets, both competitive and otherwise.[127] Other evidence referred to - that price changes are aligned - is similarly unconvincing in a market where a large proportion of suppliers' costs are determined by the same exogenous cost factors. Of more significance is that Ofgem has actively and extensively brought about conditions more conducive to tacit coordination.

Vertical integration. "Vertical integration is prevalent in this market. It can provide efficiency benefits but can also harm competition. A full investigation of the balance between costs and benefits is needed, to establish whether vertical integration is best for competition."
Comment: When the market was opened to competition, the regulatory framework left it to the market to decide whether vertical integration was more economic. For the most part, but not exclusively, the market has voted in favour of vertical integration. Any finding that vertical integration was less efficient, or hindered retail competition in the residential (domestic) customer market, would have to explain why this is apparently not the case in the industrial customer market, where Ofgem finds no cause for concern.

Barriers to entry and expansion. "Barriers identified in our report included credit and collateral requirements, low wholesale market liquidity, extensive industry regulation, and policy uncertainty."
Comment: All these factors, which if anything have increased in severity since 2008, have not deterred new entry, which has increased since 2008. As noted earlier, this suggests that entry has become more profitable since 2008, as a result of higher prices, consistent with the predictions of the effect of Ofgem's policy. However, this entry has been entirely by small suppliers. According to evidence submitted, extensive industry regulation and policy uncertainty have deterred other potential entrants.[128]

5.7 Analysis of supplier profit margins and cost efficiency

A key justification for almost all market investigations is that profits are too high. This is played down in Ofgem's market investigation reference. There is no discussion of profits until two thirds of the way through the reference, and then it is in muted terms:

> … annual domestic supply profits increased from £233m to £1,190m. In the same period earnings before interest and tax increased as a percentage of sales for domestic supply of energy from 0.9 to 4.3 per cent. We also found signs that costs may not be efficient across the industry as a whole. These are indications that competition may not be effective throughout the market, but we have not been able to conclude whether profits are excessive.[129]

These averages conceal considerable variation by supplier and by fuel, but it would presumably be difficult to argue that an EBIT of 0.9% of sales is excessive. Whether 4.3% is excessive will be for the CMA to decide. The key point is surely the significant *increase* in EBIT since 2009,

[127] Sam Peltzmann, "Prices rise faster than they fall", *The Journal of Political Economy*, 108(3), June 2000, 466-502.
[128] "5.13. Uncertainty about the future direction of energy policy and regulation may also deter potential entrants. One supplier said that energy policy and regulation creates uncertainty about costs. One potential entrant which had seriously considered entering the domestic market in the last few years told us it was deterred by both the complexity of regulation, the changing regulatory framework that applies to domestic supply, and also the political risk." *State of the Market Assessment*, p 79.
[129] *Decision to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain*, Ofgem, 26 June 2014, para 3.32.

and the key question is what caused that. I have suggested above that Ofgem's change in regulatory policy was responsible, and have so far seen no other proposed explanation.

In the passage just cited, the *Decision* document refers to "signs that costs may not be efficient across the industry as a whole". It noted considerable and continuing variation in costs from the most to least efficient supplier. It then claimed that the lack of convergence in supplier costs was an indicator of lack of competition.

> 6.35 We would expect costs to be driven down towards efficient levels over time after competition is introduced in a well-functioning market….6.36 … In 2012, the IPPR noted that the differential appeared to have widened, indicating that competitive pressure was failing to drive convergence in supplier costs, as should be expected according to economic theory. …6.37 …The variation in indirect costs among the major suppliers has remained significant over time with little convergence in costs, as one might expect if competition were driving down costs to the efficient level over time. (p 110)

The cited IPPR publication argued that economic theory would predict this.[130] In support of this it cited the *Initial Findings* of Ofgem's Probe.[131]

If there were indeed such an unambiguous thing as "the efficient level" of costs, and if variations in supplier costs reflected variations in awareness and ability, and if no other factors were operating in the market, then one might indeed expect learning over time – and/or exit from the market – to drive the costs of all suppliers towards this efficient level. But that is only half the picture. At the same time as the less efficient suppliers are trying to learn from and catch up with the more efficient ones, the more efficient ones are trying to stay a step ahead, by finding yet more efficient and less costly methods of supply. There is no reason to think that the less efficient suppliers will learn faster than the more efficient ones – if anything, one would expect the opposite, in which case cost differentials would increase over time rather than reduce.

Thus, the lack of convergence in suppliers' operating costs is not an indication of lack of competition. Rather, the presentation of this naïve and fallacious argument is an indication of lack of economic competence. It is surprising that Ofgem, the OFT and the CMA jointly endorsed it.

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130 "2.3.1 In a fully competitive market, economic theory would suggest a tendency for the aggregate costs of different suppliers to converge (Ofgem 2008), since the primacy of cost as a consideration for consumers when buying energy, and the absence of any r eal differentiation in the product would tend to drive out higher-cost competitors." Institute of Public Policy Research, *The True Cost of Energy*, London, April 2012, Section 2.3.1 p 25

131 "7.86. The cost data provided to us by suppliers shows a wide range of operating costs per account, with the cost per account of the highest cost supplier around 90 per cent higher than those of the lowest - a difference of around £20 per account per year, or about 4 per cent of a dual fuel bill. Once again, this evidence is not consistent with an effectively competitive market, where we would have expected such material cost differences to have been competed away." Ofgem, *Energy Supply Probe – Summary of initial findings*, October 2008, para 7.86 p 96.

6. Why has Ofgem gone wrong?

Why has an experienced and respected regulatory body with a duty to promote competition, and with a history of successfully doing so over nearly two decades, suddenly embarked on a set of policies, some of which are blatantly anti-competitive in nature, and seem to be costing customers about £1 bn a year or more?

I explore here three possible explanatory factors. First, the path of energy prices could have put pressure on the regulator to Do Something. Second, a series of actual and prospective changes in Government policy and the statutory regulatory framework could have influenced the policy adopted by Ofgem. Third, the changing extent of involvement of economists in senior roles at Ofgem could have affected its ability and willingness to understand and promote competition and to resist pressure from Government and media.

6.1 The path of energy prices

Public choice theory and supporting empirical evidence suggest that regulators and governments feel the need to Do Something when customers are concerned about prices, regardless of whether they are actually in a position to improve the situation. Could this have been a consideration driving Ofgem's change of policy since 2008?

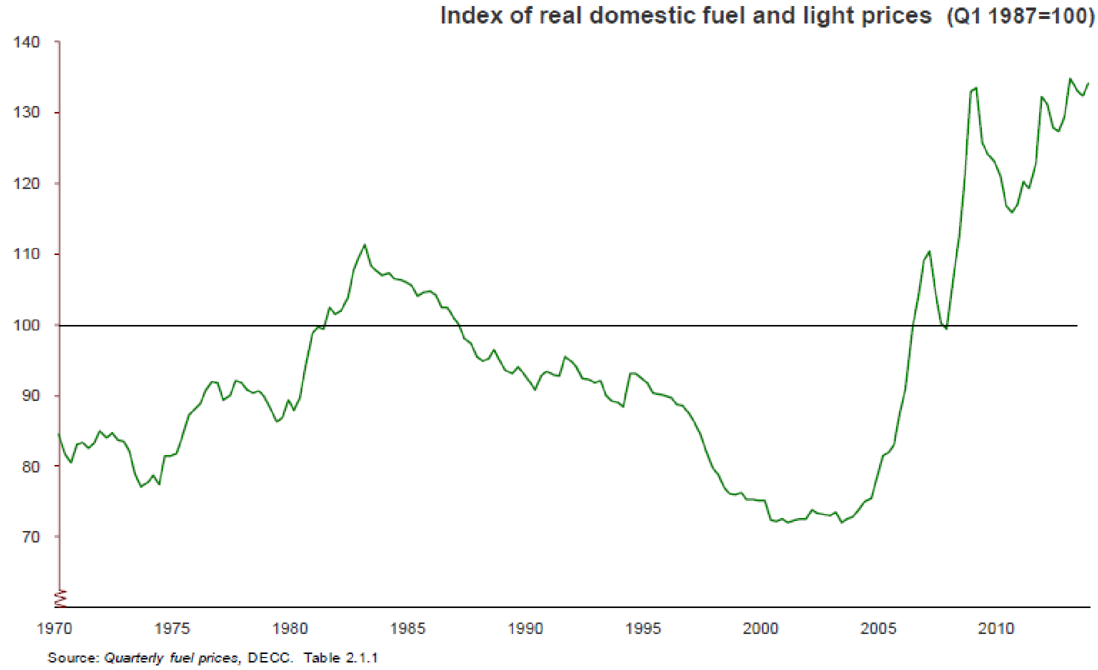

Figure 4 Index of domestic energy prices since 1970[132]

Figure 4 puts the events of the last few years starkly in context. For two full decades, from about the mid-1980s to the early 2000s, the UK enjoyed domestic energy prices that were steadily falling in real terms. They fell in total by about one third over that period - the most benign such period in living memory. In the next five years energy prices nearly doubled in real terms - the steepest and most sustained increase in living memory. Finally, in the last five years they fell significantly then increased again - the most erratic fluctuation in living memory.

[132] Source: House of Commons Library, *Energy Prices*, January 2014

As has become increasingly clear from subsequent developments and more open discussion, the causes of the significant retail price increases over the last decade include increases in international fuel costs, increases in regulated transmission and distribution use of system charges, and the costs of increasing Government obligations on the energy sector as part of its social climate change policy. The latter had both direct costs (e.g. various subsidies for renewable energy and other obligations on energy suppliers) and indirect costs (e.g. requirements to phase out coal-fired generation). The Government had no particular interest in encouraging greater realisation of its own contribution to increasing energy prices. Now, we read headlines like "We cannot stop fuel bills rising – minister".[133] Followed by Government action to transfer some of the costs of its own policies to taxpayers.

However, for most of this recent period, there was no such open acknowledgement of external factors. Ofgem had to explain all this to consumers, electors, politicians and ministers still suspicious of the privatised energy companies created in 1990. How could a well-functioning market deliver the rising and erratic prices they had observed since 2005? Ofgem investigated the retail market annually from 2002 to 2007, and on each occasion found it broadly competitive, and pointed to exogenous cost increases. But did consumers and electors, and importantly the Government, believe it? Did they want to believe it? It was often more convenient to imply that energy suppliers were the problem, and that stricter regulation of them was the way to ameliorate the problem. And from late 2008 onwards that is broadly what Ofgem and the Government said. No wonder that customers today are reported to lack trust in the major energy suppliers.

6.2 Government policy and Ofgem's responsibilities

But why did Ofgem policy change in 2008? Like other utility regulators, Ofgem has to work with the relevant government minister and department on many issues. The minister also appoints the Chairman, Chief Executive and members of the board of such regulators. Could changes in governments, ministers, energy policy and Ofgem's statutory responsibilities over this period explain Ofgem's change in policy? We may identify four distinct phases of Government.

(1) Conservative Governments May 1979 – April 1997

Conservative Governments were in power from May 1979 to April 1997, during which period The Gas Act 1986 and Energy Act 1989 privatised the gas and electricity industries. These Acts created the gas and electricity regulators Ofgas and Offer which, like other utility sector regulators, were independent bodies, responsible to Parliament but not to ministers or the Government of the day. The Acts gave regulators and ministers relatively simple statutory duties, primarily to promote competition and to protect the interests of customers. These Conservative Governments explicitly rejected the concept of an energy policy.

(2) Labour Governments May 1997 – September 2008

For another decade the senior energy minister (there were eight during the decade) was generally a moderate in the pro-market Labour Government of Tony Blair and the first fifteen months of Gordon Brown's Government. Over this period and subsequently, Governments of all persuasions gradually developed a more active approach to energy policy. They diluted the duty

[133] *The Times*, Monday October 14, 2013, p 1.

to promote competition, gave the sector regulators additional duties, and took powers to guide the sector regulators in their discharge of these duties.

For example, during this period the Utilities Act 2000 replaced Ofgas and Offer by the Gas and Electricity Market Authority (GEMA), the governing body of Ofgem. It modified the original regulatory duty to promote competition to read “to protect the interests of consumers in relation to electricity conveyed by distribution systems, *wherever appropriate* by promoting effective competition” (italics added). It specified that “consumers” should include both existing and future consumers. It required GEMA to publish a forward work programme before each year. It provided that “The Secretary of State shall from time to time issue guidance about the making by GEMA of a contribution towards the attainment of any social or environmental policies set out or referred to in the guidance.” Subsequent Acts until 2008 moved a little further in these directions, particularly with respect to environmental duties. In particular the Energy Act 2008 added to GEMA’s duties “the need to contribute to the achievement of sustainable development”.

However, by comparison with later periods, only limited steps were taken during the first Labour Governments up to September 2008.

(3) Labour Government October 2008 – April 2010

On 3 October 2008, a new Department of Energy and Climate Change was created, headed by Ed Milliband as Secretary of State. Although part of the same Labour Government, he had a different, more interventionist, perspective than his predecessors. On 16 October, two weeks after taking office, he announced the intention to cut greenhouse emissions by 80% by 2050 rather than 60%. Within five months, in April 2009, he had “overturned the old energy department stance” on coal-fired power stations, announced a “complete rewrite of UK energy policy”, and indicated that important decisions could not be left to the market.[134]

The new Minister’s view on Ofgem’s new regulatory policy soon became clear. On 9 December 2008, making “his first major speech on UK energy policy”, Mr Milliband gave strong support to Ofgem’s pro-active policy in the retail market proposed two months earlier.[135] Ofgem’s proposed package of measures including the non-discrimination conditions was formally implemented in September 2009. On 8 October 2009 the Government gave strong support to Ofgem’s revised approach and foreshadowed further changes.[136]

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[134] “‘This is a complete rewrite of UK energy policy. Instead of a laissez-faire system where companies told government they wanted to build and where, government has decided that reducing climate change emissions cannot be left to the market and it must now tell industry what needs to be built to what pollution standards,’ one government source said yesterday.” *The Guardian*, 24 April 2009.

[135] “[T]he recent Ofgem report found that millions of vulnerable customers who were on pre-payment meters, off the gas grid, or served by companies that used to be the local monopoly were losing out. … There can be no excuse for these practices, and unless all energy companies accept their responsibility for ending them, we will use our powers to do so. Ofgem set a deadline of December the first and will report shortly on what they propose. We are determined to work with them to root out unfair practices hitting the most vulnerable.” *The Rise and Fall and Rise Again of a Department of Energy*, A lecture by Ed Milliband, Energy Futures Lab Annual Lecture 2008, Imperial College London, 9 December 2008, p. 9.

[136] “The Government firmly believes that the regulator should be active in protecting consumers and their interests, whether through the promotion of effective competition or through other, more direct, interventions. We have welcomed the measures developed following Ofgem’s probe. … the Government has recently stated its intention to clarify the remit of the regulator in relation to consumer protection at the earliest legislative opportunity”. (p 8) *Government Response to the Efra Select Committee Inquiry: Energy efficiency and fuel poverty*, Cm 7719, [8] October 2009.

This clarified regulatory remit was shortly made public. On 19 November 2009 the Government introduced a Bill that became the Energy Act 2010. This Act specified that the interests of electricity consumers "are their interests as a whole including their interests in the reduction of electricity-supply emissions of targeted greenhouse gases, and their interests in the security of supply of electricity to them". This perhaps implies that these interests are not best served by leaving customers to decide for themselves in the market. The Secretary of State and Ofgem still had the duty to carry out their functions "wherever appropriate by promoting effective competition", but this was now qualified: they were now required to consider "whether there is any other manner (whether or not it would promote competition) … in which [they] could carry out those functions which would better protect those interests". According to the Explanatory Notes accompanying the Energy Bill,

> Competitive solutions may take time to deliver, and the market may create barriers for some groups of consumers so that the promotion of competition may not be the most effective means of protecting their interests. These provisions clarify that Ofgem should consider using alternative types of solution to address the consumer detriment instead of, or alongside, measures to promote competition. Such solutions could include strengthened licence conditions and enforcement action, or other means that would prevent certain types of market behaviours. [137]

The main purpose of the change in Ofgem's duties was presumably to facilitate the Government's climate change policy. But in simple terms, Ofgem's duty to promote competition was further demoted. Instead, the regulator should look to more active regulation.

(4) Coalition Government May 2010 to date

On 11 May 2010 the Conservative-Liberal Democrat Coalition Government took office. The two subsequent Secretaries of State for Energy and Climate Change were from the Liberal Democrat party. In July the Government took the view that "The UK needs to radically increase its use of renewable energy."[138] The Government introduced a different but equally interventionist Energy Market Reform policy, described in such phrases as "the single biggest change to this country's electricity market in a generation".[139] The Government expected energy costs to rise in future, and saw regulation as part of the process for avoiding unnecessarily high prices.[140] One of the Coalition election commitments was to review Ofgem, "to ensure that the regulatory framework … would continue to deliver against our strategic objectives".[141] This review was initiated in July 2010 and reported a year later. It sought to deliver, inter alia, "confidence that the regulator's decisions would be aligned with the Government's strategic policy framework". The outcome was an additional requirement on Ofgem to further the delivery of the Government's

[137] Energy Act 2010, Explanatory Notes para 78.

[138] *National Renewable Energy Action Plan*, DECC, 1 July 2010.

[139] The policy involved feed-in tariffs with contracts for differences (CfDs) to encourage low carbon generation, a capacity mechanism to encourage investment in capacity, an emissions performance standard to restrict carbon dioxide emissions, a carbon price floor to tax fossil fuels, and a suite of requirements on suppliers to help improve energy efficiency. Others have said the UK may be moving back towards a "post second world war" era, "with a Ministry of Power and a set of blueprints for the UK's energy future." Harold Hutchinson, *Investec June Note*, quoted in *New Power*, Issue 65, July 2014, p 3

[140] "The unit cost of energy is likely to rise considerably in the future, and it is therefore important that energy companies do not inflate bills unnecessarily. All consumers and especially the most vulnerable must be respected and treated fairly. To deal with this, the Government is committed to strong regulation and zero tolerance of market abuse and poor customer service. DECC, *Annual Energy Statement*, 27 July 2010, p 5.

[141] *Ofgem Review, Final Report*, July 2011, Ministerial Foreword.

policy outcomes, to explain whether it had succeeded and to say how it would do better next time.[142]

Meanwhile, on 25 September 2010 former energy minister Ed Milliband was elected leader of the Labour party. In September 2013, as noted, he announced the energy price freeze in an attempt to "reset" the energy market which he described as "broken". He subsequently proposed "a tough new energy watchdog with power to cut unfair prices". In December 2013 these proposals became part of Labour's ten-point plan to reset the energy market. [143]

The details of these various policies are not important here. For present purposes the point is that two quite distinct government approaches to energy policy and regulation have obtained during the last 35 years, regardless of the party in power. From energy privatisation in the 1980s and the opening of retail markets in the late 1990s through until September 2008, successive governments and ministers supported the promotion of competition in energy markets and engaged in relative little intervention. In contrast, from October 2008 to date, successive governments and ministers have followed policies of direct and substantial intervention in markets, have modified Ofgem's statutory duties to subordinate the promotion of competition to more direct intervention in the market, and have increasingly required Ofgem to carry out policy specified by Government. For the most part, opposition parties have not demurred. Thus, views and practice in the period since October 2008 are all rather removed from the notion of independent regulation that accompanied the privatisation of the UK utility sectors, and that basically obtained until September 2008.

How then, if at all, did evolving government policies impact on Ofgem's retail regulation? The publicised meeting of Ofgem and the Chancellor on 8 January 2008 (see Introduction above) took place during the first phase of policy. The issue of Ofgem's press release, saying that the market is working, suggests that although the Labour Government might have wished to be seen to be pressing Ofgem for an explanation for the rising prices, the Government accepted Ofgem's explanation. It was not the Government that pressed Ofgem to investigate and intervene further via its Probe, nor did the Government dictate the kind of approach that Ofgem should adopt going forward.

Ofgem issued its *Probe Initial Findings* on 6 October 2008, just three days after Mr Milliband took office. His early endorsement of Ofgem's policy indicates that it was congenial to him, but there was not sufficient time for him to have influenced those Findings and proposals. Again, responsibility for the content of the policy lies with Ofgem.

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[142] The Energy Act 2013 provides for the Government to make a Strategy and Policy Statement. This will set out its strategic priorities in its energy policy and specify the policy outcomes to be achieved. It will also define the roles and responsibilities of various entities including Ofgem. Ofgem will be required to have regard to the Government's priorities and to carry out its functions to best further the delivery of the policy outcomes specified by the Government. Ofgem's future work programme must set out the strategy it proposes to adopt to further the delivery of these policy outcomes and the things it proposes to do to implement that strategy. And its annual report must explain how far it has contributed to the delivery of the policy outcomes, and if has failed to do any of the things it proposed to do an explanation for the failure and the actions that Ofgem proposes to take to remedy it.

[143] The plan includes ring-fencing of generation and retail supply businesses within vertically integrated companies, reintroduction of an electricity Pool, simpler tariffs with a uniform daily standing charge set by the regulator, abolition of Ofgem and creation of a tough new energy watchdog with a remit to ensure that customers get fair value from the market and with power to cut unfair prices, and creation of a new Energy Security Board to plan for and deliver on our energy needs. *Powering Britain: One Nation Labour's plans to reset the energy market,* Labour Party Green Paper, 2 December 2013.

The announcement of the RMR on 20 November 2010 did not evoke an immediate response from DECC. Ofgem's RMR Findings and initial proposals on 21 March 2011 were discussed in advance with the Coalition Government,[144] as any major regulatory policy would be. The Secretary of State issued a statement of support.[145] Likewise he supported Ofgem's further statement on 22 June 2011.[146] In September 2011 he proposed to give Ofgem more powers, and called on it "to assess whether competition was being hindered by some energy companies that have high energy prices for millions of their consumers and yet offer much cheaper online deals that make it difficult for small suppliers to compete".[147]

Ofgem's revised proposals in October 2012 were expanded to incorporate a version of the Prime Minister's own proposal. The Secretary of State supported them strongly.[148] The Prime Minister's office said that the Government "had been working with them [Ofgem] for some time".[149] Rather extraordinarily, the Government announced that it would take powers in the Energy Bill to require suppliers to do precisely the things that Ofgem proposed to implement via licence amendment. On 8 May 2013 DECC's impact assessment of its proposal to do this reproduces Ofgem's arguments moreorless verbatim.[150] The Government explained that its policy objective was to encourage retail competition through greater engagement of customers, but also indicated that its urgent aim was to keep energy prices down, time was of the essence and this would speed up the process.[151] The only implicit note of criticism are the references to the "uncertainty in the retail market due partly to the length of time Ofgem has been considering reform", and "uncertainty … created by a long RMR process" (paras 57, 62).

Thus, in its sudden change of policy in October 2008, Ofgem does seem to have been swimming with the sudden change in the political tide. Over time, and by 2011, Ofgem and the Coalition Government worked together, and the Government was anxious to implement Ofgem's policy in order to keep energy prices down. But there is no evidence that Government initiated or determined Ofgem's policy as opposed to supporting it. Responsibility for the thrust and detail of the policy seems to rest with Ofgem. Whether this policy was actually in the interests of customers, or even vulnerable customers, is another matter.

[144] At the special session on 28 February 2011 to discuss RMR issues, "the Chairman provided feedback from his recent meeting, together with the Chief Executive, with the Secretary of State DECC." Notes of a Special Session of the Gas and Electricity Markets Authority, 28 February 2011.
[145] *Ofgem energy market proposals: statement by The Rt Hon Chris Huhne MP*, DECC, 21 March 2011.
[146] "Ofgem today signalled its determination to press ahead with a radical overhaul of the retail energy market following wide support from consumers, Consumer Focus, Which?, CAB, Age UK and uSwitch along with independent generators and small energy suppliers." Ofgem Press Release R/16, 22 June 2011.
[147] *Huhne: More teeth for Ofgem, more rights for energy consumers*, DECC announcement, 20 September 2011.
[148] "I welcome the proposals Ofgem has set out today - these are the sort of measures I have been urging for some time, they represent a big step forwards in reforming our energy market to help millions of households get a better deal on their energy bills." Secretary of State's response to Ofgem's Retail Market Review, 19 October 2012.
[149] Number 10 Press Briefing, 19 October Morning.
[150] Consumer Tariffs Amendments (powers a-e), IA No: DECC0126, 8 May 2013.
[151] "46. If a power is not taken now and instead delayed, an appropriate primary legislative vehicle may not be readily available. This would significantly delay any government intervention to put proposals through, in the event that Ofgem is unduly delayed or impeded in implementing their final proposals. This would result in any potential benefits to consumers being delayed unnecessarily. 47. Also, the Government is determined to ensure that at this time when household budgets are under substantial pressure, timing is very important to ensure consumers are not paying unnecessarily high prices for their gas and electricity. Therefore the timeliness of these proposals is essential, and taking powers now is of upmost importance." DECC *Impact assessment*.

6.3 Economists at GEMA

In his Forward to Ofgem's *2012-13 Annual Report*, the retiring Chairman looked back over the ten years that he and the Chief Executive (also then retiring) had served, and commented:

> "The organisation has been formidably led by its Chief Executive, Alistair Buchanan, throughout my own period in office and I pay tribute to his energetic, expert and transformational role in leading Ofgem from a body that was essentially an economic regulator ten years ago to its current and far more multi-dimensional purpose and activities."[152]

There have been remarkable increases in the range of Ofgem's statutory duties over this period, changes in their nature, and many challenges presented by a more active Government energy policy in the context of significant and fast-moving environmental and social developments. One can appreciate the need for an organisation geared to a "far more multi-dimensional purpose and activities". The achievements of the Chairman and Chief Executive in keeping the regulatory body afloat, in often very rough seas, have been notable. But has the ten-year transformation from an economic regulator to a multi-dimensional purpose gone too far, or come at too great a cost?

Economists' concerns about the change in Ofgem's retail policy, as set out above, suggest that the influence of economic thinking at Ofgem declined over this period. Consider the extent to which economists were in key positions on the board of Ofgem's governing body GEMA over the period since its inception.

- At GEMA's inception in January 1999, the first Chairman, who was also Chief Executive, was an economist. So too had been the Directors General of Offer and Ofgem before him. After October 2003 his replacements in both positions were not economists.
- Ofgem's Head of Markets Division, who is responsible for developing its policy on retail competition, putting it to the Board, and implementing it, is an Executive Director of GEMA. That person was an economist from GEMA's inception until December 2007. His replacement as Head of Markets Division from January 2008 was not an economist.
- For two brief periods (May 2004 – June 2005, and January 2008 – October 2010), former Heads of Markets Division, both economists, were Executive Directors in other positions at Ofgem.
- A succession of Professors of Economics served as Non-Executive Directors on the board of GEMA from its inception until the resignation of Professor Yarrow in March 2009. He was not replaced by another economist as Non-Executive Director until October 2012.[153]

The total number of economists on the GEMA board, including in the critical position of Head of Markets Division, is shown in Figure 5. From January 1999 until September 2003 there were four economists on GEMA if Chairman and Chief Executive are counted as separate posts, or three if they are counted as a single post. After that, the number of economists declined. For over five years from January 2008 the Head of Markets Division was not an economist. For almost all

[152] Chairman's Foreword to Ofgem's *Annual Report and Accounts 2012-13*, Ofgem, 2013 p 5.

[153] Whether this was a result of GEMA not asking for an economist replacement or the Secretary of State not accepting one, both parties will have been aware of a "perception that Ofgem favoured highly theoretical, economically perfect market arrangements"; and "Ofgem's approach had sometimes let economic theory outweigh considerations for a more simple or practical solutions". *Ofgem Review: Call for Evidence, A Government Response*, DECC, December 2010, paras 39, 40.

of that time there was at most one economist on the GEMA board, and for a significant two-year period (from November 2010 to October 2012) there were no economists at all on the GEMA board.

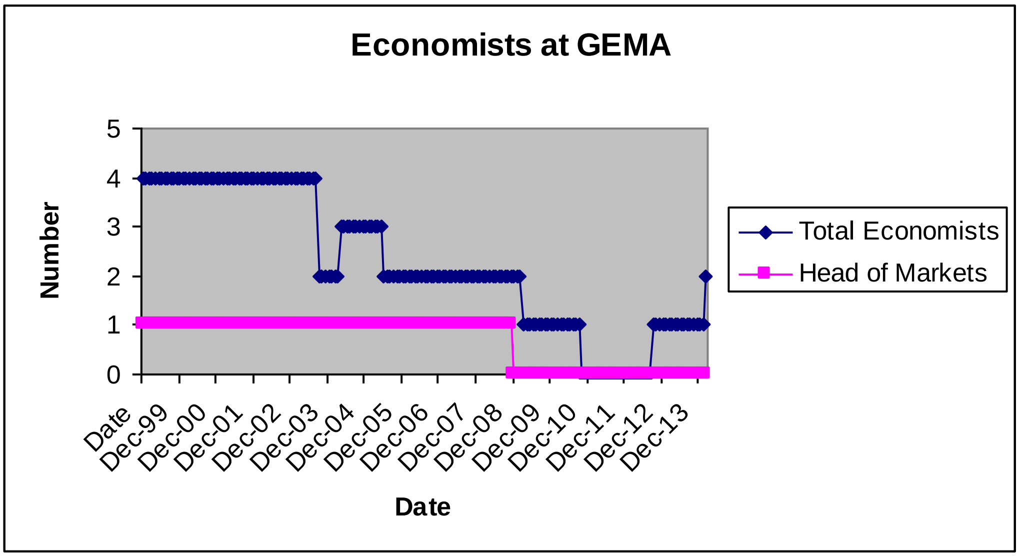

Figure 5 Economists on the board of the Gas and Electricity Markets Authority[154]

With this absence of economists at the highest level, is it surprising that Ofgem's retail analysis and policy has been at best economically uninformed and implausible, and at worst been driven through against all expert economic advice? It was in early 2008 that Ofgem started down a new path that led to a controversial and internally debated approach to retail competition.[155] In March 2009 the issue came to a head and Ofgem explicitly rejected the advice of expert economists. Since then Ofgem has simply ignored economic considerations and invented its own quack doctor remedies for the competition problems it perceives. Has Ofgem been able, since mid-2009, properly to discharge the functions of an economic regulator with respect to energy markets? Did it any longer have the technical competence and objectivity to carry out a competition review?

Thus, the decline in economic influence was not the *cause* of Ofgem's change in policy but it does seem to have removed a important sanity-check on the proposals put forward. Fortunately the situation has now changed at Ofgem, insofar as after a 3½ year gap an economist was appointed Non-Executive Director in October 2012 and the Chief Executive since March 2014 is an economist, as is the present Head of Markets. However, the rest of the GEMA Board remains unchanged, and there is no sign as yet that policy has changed. Economists seem to be a necessary but not sufficient condition for sound competition policy.

[154] Source: Ofgem *Annual Reports and Accounts*
[155] Professor Yarrow observed in his April 2009 evidence: "This conduct points to a deep incoherence/inconsistency in policy toward competition, which appears to have developed over the past fifteen months or so [ie back to about January 2008]. Until the position is rectified, avoidable regulatory uncertainty will persist."

7. Conclusions

Since 2008 Ofgem has intervened in the domestic retail energy market in increasingly restrictive ways. It has engaged in two main campaigns. Initially it imposed non-discrimination conditions to restrict the prices that suppliers could charge, with the aim of "removing unfair price differentials", particularly as between suppliers' prices in-area and out-of-area. Now it restricts the number and types of tariffs that suppliers can offer, with the aim of bringing about simpler tariffs that will encourage customers to engage in the market.

Ofgem has a legitimate concern for vulnerable customers and for facilitating engagement in the market. In both cases, however, its heart ruled its head. Its economic analysis was seriously faulty, and its policies have adversely affected customers, including vulnerable customers, and competition.

In 2008 Ofgem interpreted observed price differentials as a sign of lack of competition when in fact they were consistent with effective competition. It took it upon itself, without obvious statutory justification, to decide what constituted "fair prices" and to impose these prices on the market. Its aim was not simply to enable vulnerable (less active) customers to achieve the benefits of competition. It intended to redistribute income between customers. It explained that it was aiming to remove "unfair price differentials" worth some £0.5 billion. What it did not highlight was that it aimed to do this by increasing prices to other customers by £0.5 billion, so as to maintain revenue neutrality for the energy suppliers. Customers, not suppliers, were to foot the bill.

Ofgem sought to bring about these "fair prices" by means of non-discrimination conditions. It was warned by expert economists that these would increase prices, reduce competition and be against the interests of customers, not least the vulnerable customers that Ofgem sought to protect. Ofgem itself had decided against using non-discrimination conditions in 2000 and 2002, for these very reasons. In 2009 Ofgem overrode these objections and reversed its own previous policy, claiming against essentially unanimous professional advice that the net effect of its policy on competition and welfare was ambiguous. Its economist Non-Executive Board member resigned.

As predicted, Ofgem's policy made the retail market less competitive, not more competitive. The differences between the prices of the Big 6 suppliers reduced, rivalry between them declined, customer switching fell by about half, and the profits of the Big 6 suppliers increased by nearly £1 billion. This was at the expense of customers. It is implausible that only active customers paid the resulting higher prices: vulnerable customers, that Ofgem sought to help, are also worse off as a result of its non-discrimination policy.

Ofgem's other campaign is to increase customer engagement by simplifying tariffs. Instinctively, people like the idea of simpler tariffs, though they are much less keen when they realise what this entails. But there are two main problems. First, there is no evidence that complex tariffs deter switching or that simpler tariffs will increase customer engagement and switching. Tariffs are just as complex in Australia as they used to be in the UK, yet the switching rate is even higher there. There is extensive empirical evidence, including previous research by Ofgem itself, that customer engagement and switching are driven by the prospect of better prices or attractive deals in some form or other, not by simpler tariffs. Once again, Ofgem ignored expert advice on how the market works.

Second, the simple tariff policy prohibits many discounts and tariff types that customers value, especially vulnerable customers. Discounts for prompt payment, introductory discounts, tariffs with no standing charge, E.On's Staywarm tariff – all these are effectively prohibited. This policy restricts customer choice and the ability of suppliers to compete by offering different products better tailored to different customer preferences. The limit of four tariffs per supplier discourages innovation. So customers are suffering for no good reason, to create simpler tariffs in pursuit of Ofgem's vision when there is no evidence to believe that this will actually increase customer engagement.

So Ofgem's policy is again reducing competition instead of encouraging it. Simple tariffs have become an obsession at the expense of economic evidence, common sense and the interests of customers.

Ofgem's willingness to intervene radically in the retail market has spawned a large number of equally radical suggestions from politicians and others. None of these proposals has any economic merit in terms of promoting competition or protecting customers.

Perhaps Ofgem felt under pressure to Do Something in the face of the unprecedented increase and uncertainty of energy prices over the last decade. Successive Governments have supported its interventions, but cannot be blamed for designing them. The decline of economists in senior positions at Ofgem removed an important 'sanity check'. But Ofgem itself bears responsibility for the dramatic changes in its regulation of retail competition since 2008. The best that can be said about the policy is that it was well-meaning, attempting to protect the interests of vulnerable customers. The problem lies with the inappropriate restrictions that Ofgem imposed, against expert advice, in its attempt to achieve that aim. The outcome has been to make all customers, including vulnerable customers, worse off.

Should other regulators follow suit? The unambiguous answer is No. The policy has been a mistake. One has to hope that the CMA market investigation will reveal this and bring to an end one of the most misguided episodes in the modern history of UK regulation.