EEE Limited
38 Swains Lane
London N6 6QR

Tel: 0207 284 4217
Int: 44207 284 4217
Fax: 0207 284 4331
Int: 44207 284 4331
alexhenney@aol.com

12th August, 2014.

Mr. Roger Whitcomb
CMA
energymarket@cma.gsi.gov.uk

Dear Roger,

Energy Market Investigation

I attach extracts from my book "The British Electric Industry 1990-2010; the rise and demise of competition" to substantiate my points[1].

1. In 1994 and 1995 I expressed the view that expensively enforced mass retailing to residential customers was a pointless exercise and of no benefit to customers, see Annex1.

2. Views on the competitiveness of the market up to the end of 2007, see Annex 2. Ofgem thought that all was for the best of all possible worlds, but this view was not shared by academics nor by Energywatch, while City analysts did not see much to worry about by way of price competition.

3. The denouement came at the beginning of 2008, see Annex 3. On 13/1/08, primed by Energywatch, the Sunday Times layed into the energy companies "Rip off exposed". Nonetheless on 16/1/08 Mogg and Buchanan assured Chancellor Alistair Darling "The Market is sound" (Ofgem Press Notice 16/1/08). On 5/2/08 the Business and Enterprise Select Committee commenced an inquiry into "Energy Prices, Fuel Poverty, and Ofgem". This woke Ofgem from its complacency and it commenced its Probe. On 28/7/08 the Committee published its report and was very critical of Ofgem. On 6/10/08 Ofgem published the initial findings of the Probe, reporting various market failures. Since then it has been fiddling and fining fairly ineffectually.

4. There has been a long -and continuing - history of misselling, missbilling and poor service, see Annex 4.

5. There is no evidence that residential customers have benefited from competitive supply, see Annex 5.

6. Fifteen years of trying has demonstrated that my views were correct. A sensible approach to providing residential customers with the benefits of competition in the wholesale market (to the extent that it is competitive) would have been to copy the approach adopted in New Jersey and some other States. Namely the local distribution company is responsible for procuring competitive supplies of power, buying at auction a third of the power required for residential power it requires in three year strips that are profiled to the load with a maximum demand of about 100MW.The strips are blended so the effect for

[1] I have removed the references in the Annexes but can provide them if required.

customers is to pay for a rolling three year average price. The vendor of the strips assumes profile and volume risk, while the local distributor passes the purchase cost of the contracts through and assumes only the credit risk. The distributor is paid for administration and bad debts. Customers have the option of buying from a competitive retailer if they so wish, see Annex 6. **I advocate a variant on this approach adjusted for our particular circumstances.**

Regards,

ALEX HENNEY

Annex 1 MY SCEPTICAL VIEW IN 1994/95

During the summer of 1994 and on several occasions in early 1995 the author suggested to Offer and the Electricity Division of the Department of Trade and Industry, that before embarking on an exercise to develop a large and expensive system, it would be advisable to assess the costs and benefits of introducing competition in different ways and look at experience in other markets. The DTI was not interested; after several months delay, in a letter dated 28 April 1995 to the author, Tony Boorman responded that there was unlikely to be "time for any further in-depth study along the lines you propose". Subsequently he commented that cost-benefit analyses provided by regulated businesses and most of the benefits were difficult to quantify. But perhaps he would say that, wouldn't he!

In December 1995 the author published "The Proposals for Liberalising the Electricity Market in England & Wales in 1998 – A Poll Tax on Wires?"[1]. The report pointed out that "The Director has made a series of unsubstantiated statements asserting the benefits of competition"; that "there has been no attempt to analyse the economics of the market", nor to look at the experience of opening the electricity mass market in Norway, which had been implemented in a year with three staff and a consultancy budget of about £30,000. "To date the planning for 1998 has been driven by the political ideology of the government and the economic ideology of the Director…The approach is a recipe for another major systems disaster…A poll tax on wires is in the making."

As far as the author is aware, the analysis published in his report was the only attempt to undertake an assessment of what money there is to play for and how the market might behave. The key findings were that in 1995/96 the typical domestic customer consuming 3300kWh p.a. on a single rate tariff:-

- Paid an average of about £157 for the cost of electricity and supply. This amount would reduce with the ending of the coal contracts to about £140
- For all customers below 100kW the annual cost of supply in 1997/98 averaged about £25/customer, of which operating profit averaged about £7/customer
- For domestic customers the supply business revenue may reduce to £9, representing a reduction of about £4 annually
- Offset against the reductions were the cost of the systems being developed which may come out at about £3/customer annually, perhaps £2 for domestic customers - in the event the cost was £4 p.a.
- The effect of competition on wholesale prices was not at all clear. Perhaps there might be some tightening of buying by some suppliers that could be worth 2-3%, of which the supplier would keep part and give say £1-2 annually to typical domestic customers of those suppliers. "Expensive" IPPs will, however, have to reduce their prices, and the largest reductions will be for the franchise customers of RECs that have the largest

[1] The title was an allusion to Mrs. Thatcher's ill-fated attempt to introduce a poll tax to fund local authorities, which resulted in violent street protests on 31 March 1990 and contributed to her demise in November 1990.

proportion of IPP contracts at the highest IPP prices (around 3p/kWh). For these customers the IPP contracts currently represent a cost of about 0.2p/kWh (about £7 p.a.) over and above what they would pay for market based supplies

The overall conclusion was that there was “no justification for developing an enormous system to force feed competition to small customers”, and the report advocated a couple of much simpler approaches.

Annex 2 VARIOUS VIEWS ON THE COMPETITIVENESS OF THE MARKET UP TO END 2007

Ofgem's views

In June 1999 Ofgem published a "Review of the Development of Competition in the Designated Electricity Market" covering the residential and small business market, and concluded the prospects for the future development of competition were good, which was not surprising as there were numerous suppliers and a high awareness of competition. This was the first of a series of reports over nine years on the residential market which until the Probe had a consistent story line; the level of switching is high, which in Ofgem's view indicates that the market is competitive; those who have not switched can save money by switching (but some of those who have switched could save more); and customers are satisfied with suppliers. In July 2000 Ofgem proposed removing the non-discrimination conditions from the licences of all gas and electricity suppliers. Ofgem commissioned MORI to undertake a survey which was published in January 2001 and noted:-

> "Satisfaction with energy suppliers is very high, as in the past. No specific aspect of their service attracts significant criticism. Awareness of the suppliers in the electricity and gas markets is growing strongly, though British Gas is managing to stay ahead by a substantial margin."

All was for the best of all possible worlds.

The first hint of trouble came in February 2000 when Ofgem reported that many customers had difficulty in comparing different suppliers' prices, and concluded that the way prices were displayed by suppliers constrained customer choice. The issue of price confusion did not go away. In March 2001 Ofgem published "Making gas and electricity price comparisons easier: a decision document" and published market research whose key findings included that about two thirds of customers found that "it is very confusing working out how much you would have to pay with a new supplier." Ofgem concluded that "The results of the market research indicate that customers' key need is to be made aware that independent price comparison information is available", but it proposed no further action. In November 2001 Ofgem published another optimistic report along with another survey which included the usual claims, but noted a third of customers found it difficult to make price comparisons and "customers still rely heavily on pricing information provided by competitor and current suppliers". Then came "Regulation of gas and electricity marketing: a more rigorous approach".

Ofgem's "Domestic Competitive Market Review" in April 2004 was more comprehensive than the previous reviews. It included the customary claims that "For all customers, including domestic customers, supply competition has produced substantial benefits. Around half of domestic customers have now switched supplier…The average standard credit customer switching for the first time can save between £79 and £126 by switching to dual fuel…" But clearly switchers were not achieving such savings because "Despite often being the most expensive dual fuel supplier, British Gas supplies 44 per cent of all dual fuel customers." Ofgem also noted that "Many customers still find it difficult to compare prices and most get pricing information from a supplier. Whilst this does not imply that the information is inaccurate, it is unlikely to identify the maximum savings that could be made by the customer." The Domestic Retail Market Report in June 2007 concluded:-

> "Our analysis shows that all segments of the market remain highly competitive and not just for customers who pay by direct debit or online. The key findings are:
>
> - Vigorous price competition between the big six suppliers for all customers - the spread between prices has shrunk and the most expensive suppliers have been forced to become more competitive to stem customers losses…"

Ofgem's reports consistently showed that savings were available for customers who had not yet switched (and to a lesser extent for those that had switched), which gave it and politicians a let out when prices increase. *But a major shortcoming of these studies was that they reported what savings customers might make, not what they were actually making.* And so Ofgem went on with this storyline until January 2008, when the Chairman and Chief Executive reassured the Chancellor of the Exchequer that all was for the best of all possible worlds. Then the Business and Enterprise Committee and the Probe forced it to face reality, see chapter 10.

Academic views and customer behaviour

How customers behave is as fundamental to understanding a market as are the economics of a market. There has been a significant body of quality academic research on customer behaviour and attitudes to the competitive energy markets. Work undertaken by Professor Catherine Waddams Price of the University of East Anglia provides possible reasons why customer switching is less beneficial than it should be, suggesting that customer confusion may have an important bearing on diminishing the effectiveness of competition. Large numbers have not switched despite potential benefits from doing so, and of those who did many may simply be making the wrong choice. Some specific findings from her analysis of 3,100 customers (see "Irrationality in Consumers' Switching Decisions) include:-

- 32% of switching customers changed to an entrant charging *more* than the firm they were switching from, creating an average loss of £16.5 p.a.

- Although the average maximum annual gain available was £53.9, the annual average gain was only £12.6 (which means that customers were only taking 23% of the available benefit)

- Only 7% of customers achieved the maximum saving from their switch of electricity supplier

Waddams concluded that switching mistakes by customers were caused by "decision complexity" rather than by factors explained by conventional theories of rational decision-making. In response to surveys, only a quarter of customers find price comparisons between suppliers "very easy" or "fairly" easy". Her research did not indicate that customers in aggregate had benefited from the competitive process or that the market was becoming more competitive in its early days. Measures of market power showed no sign of reducing, and awareness of competitive opportunities seemed to have fallen.

The other surveys and analyses of the behaviour of residential gas and electricity customers in Britain have built up a clear picture of how these markets behave, concluding:-

- Customers will stay with their current supplier unless the expected benefit from switching exceeds the time costs which they expect to incur in searching for a better deal and making the switch

- Although they can save money – of the order of £40-50 p.a. - a slight majority[2] of customers will *not* switch. About 70% of customers who had not switched wrongly believe that the incumbent will reduce price to match competitive prices

- As a consequence of the previous two (related) points, the incumbent has market power and it is in its interest for many years to price above competitors' prices in the knowledge that the gain from sweating its customer base will outweigh the loss from reducing customer numbers

- One survey found that while 45% of switchers pay less for their energy, **42% pay more and 13% pay the same**. In another survey up to a third of the switching customers paid *more*, while those who gained only gained a quarter of what they might have saved if they made an optimal choice

- Having more suppliers can confuse customers and result in poor choices

- Markets are far from competitive, and there is no evidence that benefits have exceeded costs

[2] Now, if the research were replicated, it would read "a significant majority will not switch" (viz 40%).

During the early years of the decade Ofgem ignored these issues because prices were low, but eventually its Probe confirmed these findings.

City views

City analysts did not share Ofgem's views about the vigour of competition. Thus in February 2007, when there were limited price reductions, Merrill Lynch commented "In our view, the recent price cuts do not constitute a price war. The magnitude of competitor reductions across all tariffs will depend largely upon each company's forward hedge position in wholesale gas and power, and the assumed desire to repair retail margins, particularly in gas." On 19 February Citigroup concurred commenting "Press reports of a price war among UK energy suppliers are, in our view, misleading. While the industry no doubt welcomes the publicity the price cuts actually announced so far by PowerGen and Npower are the minimal reaction we would expect to see in response to Centrica's new tariffs."

Energywatch's views

A significant factor in the market was the creation by the Utilities Act 2000 of Energywatch as a separate statutory body created to represent customers (replacing Ofgem's consultative councils). In 2003 Australian Alan Asher, who had both economic and legal qualifications and had been deputy chairman of the Australian Competition and Consumer Commission, was appointed chief executive of Energywatch. He had little time or interest in the polite games that some poms play and was very critical of Ofgem.

In April 2007 Energywatch pointed to gas and electricity prices increasing by 19.8% and 15.8% respectively in real terms from 2005 to 2006; to the failure of independent suppliers; to barriers to effective competition; to the numbers of customers who had not switched and the high regional HHIs; and to other shortcomings in the market. It concluded "There is a growing body of evidence that suggests that competition is less robust in Britain than generally asserted by policy makers and regulators and that many features of energy markets in Britain are operating against the interest of customers."

Ofgem's chief executive, Alistair Buchanan, responded to Energywatch's report: "Ofgem's research shows that customers are punishing firms that do not deliver on price and service - switching rates remain strong. Suppliers are responding by cutting prices, improving service and developing new energy products to attract and retain customers."

In a report for Energywatch Professor Stephen Davies of the Centre for Competition Policy at the University of East Anglia set out a series of concerns about the state of competition in retail energy markets within a framework that drew on the Competition Commission's guidelines for market investigations, especially the assessment of competition. Davies noted the concentration of the market; the barriers to entry and expansion; market concentration; the potentially adverse effects of vertical integration; and that "it seems to be widely accepted that both incumbents and British Gas are charging 'high' prices, at least in their regions of previous incumbency." Turning to switching, he was not convinced that arguments about switching provided evidence of market effectiveness because:-

- "Contrary to expert opinion switching to entrants [by which he meant any non-incumbent player in a particular region] has been very moderate: 22% over a seven-year period in aggregate implies about 3% a year"
- There is a lot of academic research and evidence that much switching is, in fact, ill-advised and misinformed, perhaps because of customer confusion or mis-selling"

He concluded "evidence of switching is clearly **NOT** proof of competition per se."

The differing views on the significance of switching as an indicator of competitiveness were again aired in 2008 before the reality of the Probe changed Ofgem's view of the market:-

- Ofgem stated in April 2008 that British households switched 5.16m electricity accounts and 3.98m gas accounts in the previous year, the "highest level of switching for five years", and argued this trend showed "that suppliers who don't offer competitive prices and good service will lose customers"

- Energywatch replied that the government and Ofgem should not "get carried away" by the figures because "No-one can seriously think that switching, by itself, provides the answer for Britain's besieged energy consumers. It becomes little more than an academic exercise to point to the best deals in the market and to use these as the basis on which to calculate the savings that are available to low-income consumers." Energywatch claimed that the market required a competition investigation

Annex 3 OFGEM UNDER FIRE

Rising prices from mid 2005 brought a new factor into the assessment process for the effectiveness of the market, namely the increasing number of customers in "fuel poverty". There were increasing perceptions that a comfortable oligopoly had developed. British Gas was seen by many as the market leader, increasing prices first (it was the most exposed of the six to wholesale electricity prices), followed in short order by the rest, with Scottish and Southern Energy usually the last, pursuing its "responsible pricing" policy. Also there was the continued prevalence of significantly higher prices for prepayment customers, who were generally on lower incomes, which concerned poverty lobby groups and the government.

In late 2007 and early 2008 the electricity market was turbulent, and energy prices were high on the political agenda. Five of the six major suppliers announced significant increases of the order of 15% in their household electricity prices early in 2008[3], which led to the average combined average household bill for electricity and gas now exceeding £1,000 - the combined increase had averaged 55% over the past three years. The Chancellor of the Exchequer summoned the chairman and chief executive of Ofgem to see him on 16 January. Following the meeting Ofgem issued a press release titled "Market is sound – Ofgem assures Chancellor", and they "confirmed that Britain's competitive market in energy is working". Energywatch did not agree and was behind the strident headlines in The Sunday Times on 13 January 2008 "Energy rip-off exposed" and "Big six energy companies profit by inflated prices". On 5 February the House of Commons Business and Enterprise Select Committee launched an inquiry "Energy Prices, Fuel Poverty and Ofgem".

On 21 February Ofgem launched its "Probe into the energy supply markets" because (according to Buchanan) of "public concern about whether the market is working effectively…but to date we have seen no clear evidence that the market is failing. Nevertheless, recent events in the market have increased public concern and have damaged customer confidence that competition is working well and giving them a good deal."

---

[3] Domestic price increases (%) levied by Big Six since 1 January 2008.

	Electricity	Gas	Effective date
RWE Npower	12.7	17.2	04 Jan 08
EDF Energy	7.9	12.9	18 Jan 08
British Gas	15.0	15.0	18 Jan 08
Scottish Power	14.0	15.0	2 Feb 08
E.ON UK	9.7	15.0	8 Feb 08
Scottish and Southern	14.2	15.8	1 Apr 08

Further criticism of Ofgem and its views came fast. In April Energywatch published a report that was very critical of the operation of the market behaviour of the Big 6, calling for an inquiry by the Office of Fair Trading. Section 6 of the report was titled "Failings of regulatory oversight", and accused Ofgem of:-

- **Allowing consolidation by default to the Big 6**. Energywatch pointed out that the Parliamentary Public Accounts Committee warned in 2003 that Ofgem should take seriously the risk that vertically integrated companies may exploit their position, and Ofgem "should adapt its competition analysis of the wholesale market and the retail markets to reflect the new reality of the market"

- **Minimalist oversight of supply**, pointing out "Since 2002 Ofgem has produced occasional reviews on the state of competition, which have tended to focus almost exclusively on national switching levels…It has not issued any analysis on the business markets since summer 2003"

- **Defending the incumbents**. In response to dissatisfaction among some politicians and stakeholders over suppliers' resistance to curbing prices after the collapse in oil prices from mid 2006, Ofgem maintained that it was examining supplier behaviour but that competition was fundamentally vigorous and effective. No hard analysis was presented to substantiate these claims beyond generalised, high-level switching data. On 8 February 2007 the regulator described British Gas decision to cut prices in March that year as "the first shot in what Ofgem expects will be the start of another battle for consumers"

- **Relying too much on self-regulation**. Regulatory moves to improve the situation for customers have been dominated by Energywatch, rather than Ofgem. Citing various initiatives including the "Stop now" campaign in January 2002 to cut out mis-selling; the customer transfer programme in June 2003 to improve the switching process; and the "Better billing" campaign which eventually led to the establishment of the Energy Supply Ombudsman

In June, undermining Ofgem's reported claims about how satisfied customers were with the supply companies, market research for the government looked at the public perception of the electricity industry in a Consumer Condition Survey. The survey rated 45 UK markets to derive an overall Consumer Confidence Index. Gas and electricity came lowest - below betting and gambling, second hand vehicles and estate agents! Gas and electricity was the only industry to rank both *low* on quality, price, choice, expectations, consumer rights and advertising, and also *high* on complaints.

Then the Business and Enterprise Select Committee published its report on 28 July 2008. It was concerned about the energy markets and was very critical of Ofgem, concluding:-

> "We have concerns that the UK's energy markets are not functioning as efficiently as they should…We are concerned that Ofgem's terms of reference suggest it may

pay relatively little attention to the wholesale markets…Our overall conclusion on the functioning of both the gas and electricity wholesale markets is that there are significant questions that need to be addressed in the interests of both retail and business consumers…We have also identified important issues that need to be addressed in the retail market itself. We have, however, recommended consideration of the merits of referring only two aspects of the markets to the Competition Commission at this stage (the forward gas market and the supply of electricity to the SME sector), and then only if Ofgem is unable to take sufficiently robust steps itself."

Annex 4 SELLING, MISSELLING, MISBILLING AND POOR SERVICE

The Big 6 put significant effort into direct sales as an effective means of acquiring new customers, with annual expenditure on direct sales by averaging around £250 million per year over recent years, an increase from the early days of domestic competition. (7.64) Doorstep selling has proved the most effective way of accessing customers, although it is also the most expensive (£30 up to £60 per customer by the better agencies for dual fuel accounts). Telemarketing (about £25/customer acquired), direct marketing to existing customers, and mailshots are becoming prevalent as companies "up-sell", for instance converting single fuel customers to dual fuel accounts, or moving dual fuel customers to higher profit products such as fixed term offers.

The internet has become important and created a significant new intermediary sector for online price comparison services which search the market for competing offers for a customer and evaluate their likely costs. Many will also facilitate the sign-up process with the chosen retailer. Suppliers have used television advertisements, billboards, the press and sponsorship deals to advertise their brand and products. There have been some "affinity" deals with suppliers linking up with well known brands such as EDF Energy and Virgin (which did not work out) and then with Nectar cardholders; PowerGen and Tesco Club Card; Scottish and Southern and airmiles.

The Probe found that over half of the customers who switched did so in response to an approach by a salesperson from one of the companies claiming that his or her offering was cheaper and only 35% switched as a result of their own enquiries (*5.6*); only 18% of those who switched consulted a website (*5.13*).

Misselling has a long history and an equally long history of Ofgem seemingly ineffectually trying to get the companies on the straight and narrow. On 30 January 2002 Ofgem published a press notice "Ofgem keeps up pressure on suppliers to reduce misselling", which was followed by a consultation document "Regulation of gas and electricity markets: a more rigorous approach" in August 2002, stating its intention to "take tough action against suppliers who do not comply with their licences". Six years later we read: *To prevent mis-selling, there are conditions in the energy supply licences which govern the processes that energy suppliers must have in place. At the beginning of this decade, mis-selling was seen as a very serious problem. Many customers were being switched without their consent. In November 2002 Ofgem imposed a penalty of £2 million on London Electricity, part of EDF Energy, for breach of these obligations. Following this, the industry introduced a self-*

regulatory code and the number of Energywatch complaints about mis-selling fell sharply. But in April 2008 Ofgem launched an investigation into mis-selling by RWEnpower which resulted in a fine of £1.8m. (2.13)

In April 2005, Ofgem received a supercomplaint from Energywatch under the Enterprise Act 2002, claiming that the billing processes of gas and electricity suppliers were significantly harming the interests of domestic consumers. Ofgem found that for the vast majority of consumers the market was working well, but for a relatively small number of consumers who had reason to complain, there were problems: complaints were resolved slowly, they often suffered great inconvenience and did not always receive adequate compensation. (2.22)

Ofgem required suppliers to do three things: establish and fund a new energy supply ombudsman to look into and resolve complaints and award customers compensation of up to £5,000; write off any amounts owed by customers where a supplier had failed to send them a bill for over twelve months; and review their supply contract terms and conditions to make them simpler and easier to understand. The suppliers complied with all three requirements by July 2006. (2.23)

The Guardian Newspaper of 21 February 2009 publicised the persistence of Robert Bramwell, a retired art teacher, who calculated that his gas bill from RWEnpower overcharged him by £26.83. If his bill was wrong then many other bills were wrong. He first complained to RWEnpower, who refunded him £50 as a "goodwill gesture" while refusing to admit error. His complaint to the Energy Ombudsman fell on deaf ears, so he contacted Guardian Money and the BBC's Watchdog programme which publicised the issue. He complained to Energywatch, who made a formal complaint to Ofgem that many customers had been overcharged. Ofgem ordered RWEnpower to repay £1.2m to 200,000 customers.

Based on talking to customers, Which? concluded "Most energy suppliers provide bills that their customers find overly complicated and confusing…A lack of clear or accurate information make it very challenging for consumers to determine whether the tariffs available are good value for money or how long a 'good' deal may last. 70 per cent of consumers find the number of tariffs available confusing and just over half find it too hard to work out whether they would make any saving if they did switch…In the latest Which? utilities satisfaction survey, energy suppliers received an average rating of just 43 per cent, lower than any other industry covered by our satisfaction surveys in the preceding 12 months"…Which? asked for clearer information on bills and on marketing information.

The experience of Forest Housing Association[4] in north-east London with 125 dwellings (of which about half are for elderly people) dealing with the Big Six illustrates the lack of care of some of the companies. According to the manager their practices include:-

- Poor service from call centres – it is rare that a call is answered in less than 5 minutes; often the waiting time is up to 12 minutes. The many options to choose from can confuse the elderly who cannot remember which number they need to press
- Over-estimated bills when a person decides to change energy suppliers
- When a flat is vacated there is little or no consumption, yet some suppliers not only charge the Association for estimated usage, but without notice switch the tariff to the most expensive one
- Some suppliers charge customers to have meters removed or changed. As the Association is removing meters from vacant flats, £60 or £70 each time soon adds up

The best company to deal with is British Gas, which has set up the 'Multi-Tenancy Team' for housing associations. The staff in some companies are rude, aggressive and obtuse. She comments "I believe that utilities have become very arrogant in their treatment of customers. Anyone who is not literate enough to express themselves clearly, or does not know which threats to make, risks not being treated fairly."

On 2 September 2010 Ofgem published a Press Notice headed "Ofgem launches investigations into misselling and sets up hotline for consumers to report misleading energy sales" – it was launching an investigation into RWEnpower, Scottish Power, Scottish and Southern Energy and EDF Energy to determine if they are complying with new obligations. What goes around, comes around.

[4] The author is a director.

Annex 5 HAS COMPETITIVE SUPPLY BENEFITED RESIDENTIAL CUSTOMERS?

A thorough analysis in 2003 by Dominic Maclaine, then editor of respected industry newsletter Power UK, for his doctoral thesis questioned the overall merits and benefits of competition to mass market customers in the early part of the decade. Ofgem's Energy Probe has now shown conclusively that many – perhaps most mass market customers – have not benefited at all.

Officialdom's party line

As described in the previous chapter, Ofgem published many reports claiming the market was competitive, which carried with it the unspoken assumption that therefore customers had benefited. But it never reviewed the back of the envelope figures provided by the DGES to the Select Committee on Trade and Industry which claimed customer benefits of £6-8bn p.a. which would supposedly come from:-

- More efficient purchasing; and greater competition in generation. But with vertical integration there is neither more efficient purchasing nor greater competition in generation
- Additional electricity consumption. The government has just committed to a spend of the order of £10bn in net present value terms rolling out smart electricity and gas meters, whose main justification is to *reduce* consumption

There was no mention on the back of the envelope of the £¾bn p.a. cost of competition spent on gas and electricity (say £375m on electricity), nor was there any mention of the cost to customers of switching[5].

Ofgem's first study concluded that by June 2000 (about a year after the roll-out of the mass market had been completed), over 6 million electric customers had switched suppliers, thereby saving in total about £300m a year representing a reduction of an average of £45 per year. *But more than half these savings stemmed from the tighter controls on regulated distribution network charges implemented in 2000.* Then, as mentioned in the previous chapter, in December 2002 Ofgem made the grossly misleading insinuation that as a result of competition residential bills had fallen by up to (a phase beloved by insurance salesmen) 17% in real terms, with an 8% reduction for customers who had not switched. But

[5] Customers incur time in the administration of switching; may incur time researching their choice; and may incur time spent sorting out administrative muddles such as mis-billing, which for about 4½ million electricity switches annually could be of the order of £¼bn p.a. (i.e. £50 per switch). It is not surprising that Ofgem never revisited these figures.

reductions in network costs had accounted for a 9% real reduction in charges over the same period, and wholesale prices had reduced.

In 2001 the NAO reported that by June 2000 6.5m residential customers had switched electricity retailer, saving £143m annually (roughly 8% or £23/customer who had switched). Offset against this saving was an annual cost of £121m for the infrastructure systems, which all customers were bearing. Thus, while some customers were saving, others were worse off. *But he did not point out that the benefits were gained relative to lax price controls which the regulator had set in order to artificially jump start "competition" by providing headroom for incumbents, see below.* The NAO noted that "many customers find it difficult to compare prices and few customers shop around for the best deal…40 per cent of customers who expressed a view said it was very or fairly difficult to compare prices." The report also noted that "Customers' reliance on sales agents is unlikely to maximize the savings that they may be able to achieve in the market…Not surprisingly given customers' reliance on sales agents for information, and the difficulty of drawing comparisons, we found that many of those who had changed their electricity supplier were not on the cheapest available tariff for their preferred payment method. By changing supplier again, some 88% of switchers could save a further £104m between them." In addition there were some highly publicized problems about misleading selling techniques employed. The Energy Probe showed that all of the foregoing problems endured for another seven years, which is no credit to Ofgem.

In March 2008 the NAO published a report examining the removal of price controls by the sector regulators in various services including energy. The report cautioned that not all energy customers had "been able to apply competitive pressures … markets through switching". It said "some problems remain" particularly for vulnerable customers who "are still unable to take full advantage of the competitive market for a variety of reasons, including complex tariffs and a lack of easily accessible, trustworthy, relevant, understandable and comparable information."

<u>Maclaine's estimates</u>

Maclaine argued that opening competition for customers rather than continuing with *effectively* regulated franchise supply resulted in significant net costs for them. *Critically he noted that "setting the price controls to 2002 laxly to encourage new entrants into the market and for regional incumbents to compete out of their areas, was intended to force* *incumbents to cut prices so making the price restraints redundant. But this did not happen to any significant extent*."

Maclaine pointed out that Ofgem initially proposed that the restraints for the standard domestic tariff should fall on average by 9.9% in real terms based on large falls in generation costs and planned at £25 reduction in standard domestic tariffs – bringing them down from £252 to £227 (in 1999/00) prices. The RECs and Littlechild lobbied that the cuts were too deep. According to Littlechild "…tightening the control in this way would severely reduce the incentive on customers to seek out and switch to the best supplier. This would correspondingly reduce the incentive on existing suppliers to compete and on new suppliers to enter the market." He claimed that "to get the benefits of lower prices consequent on such efficiency improvements, customers should look to competitive suppliers." In essence, Littlechild argued that setting tighter controls would reinforce a regulation culture, which would have a detrimental impact on the market's operation. He advocated an ersatz form of forced (so called) competition which meant that the many customers who have not switched were consigned to paying more than was necessary in a properly regulated arrangement, and profits were thrown at incumbent suppliers. In the event Ofgem changed its proposals arguing that there was a need for "headroom" in the price controls to encourage activity – "to encourage the retention and new entry of competing suppliers". The assumptions on generation and supply cost reductions were relaxed; Ofgem anticipated that the restraints would only result in a £15 cut in standard domestic bills, which implied a real reduction of 6% in the first year and for the prices to remain at their nominal levels in the second year. Ofgem claimed that the final 2000 proposals left scope for competing suppliers to offer prices at least 5% below the levels implied in the restraints.

Green analysed the economics of the situation, drew attention to the disbenefit to many customers, and concluded "Only the possibility of competition becoming more effective over time could justify a policy which raised prices to most consumers in order to increase the "headroom" for entrants in a low-margin business". But as we have seen, competition did not become effective.

In terms of the benefits, Maclaine noted that some customers benefited more than others from the introduction of competition, notably those who paid by direct debit, while prepayment customers, who very often are poorer customers, "lost out" compared to other types of customer. He argued that the lax price controls aimed at artificially inducing switching from incumbents cost those who did not switch should be counted as a cost.

Maclaine's assessment was that the introduction of retail competition led to a *net present* loss of between £292m and £1031m compared with counterfactuals of:-

No competition, regulated environment where wholesale price changes are passed on	a net present benefit of between £1220m and £1652m
Competition, tougher price controls	between a net present *loss* of £325m and a benefit of £157m
Competition, different technology route and tougher price controls	between a net present *loss* of £161m and a benefit of £941m

The evidence from the Probe and other Ofgem documents

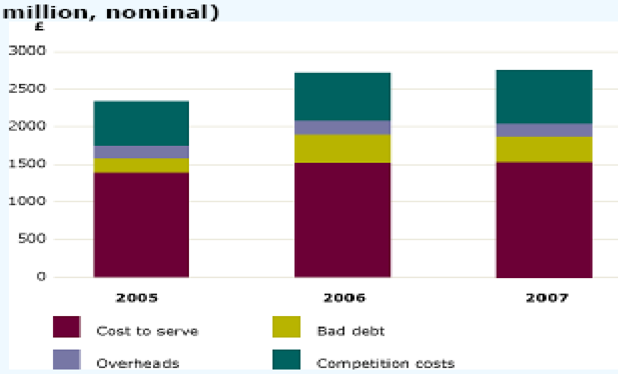
Although the Probe did not purport to undertake a cost-benefit analysis of competitive retailing, there are pointers in it which indicate that mass market customers have not benefited, particularly those who have not switched supplier. The Probe found the following:-

Customers who have switched have made trivial savings: *Overall, the average net saving made by those consumers who switched ranges from 1 to 2 % for gas customers and 3 to 4 % for electricity customers in this sample (4.19).* But 40% of those switched did not save anything.

Supply costs have increased: *All aspects of supply business costs have increased since 2005 - cost to serve by 11 %, the cost of competition*[6] *by 21 % and bad debt by 71 %...Increases in the costs to serve do not seem to be consistent with a relentless drive towards increased efficiency. (7.83)* ***Rising competition related costs could be beneficial if they result in more effective competition, thereby driving prices down, efficiency up and improving service quality. If this is not the case, these costs could be regarded as inefficient from a consumer's perspective.*** *(7.84)* (Emboldening added).

[6] Viz the costs of customer acquisition and processing switches including unscrambling the data errors.

Figure 7.11: Breakdown of supply business costs for GB energy supply (£ million, nominal)



Source: Ofgem

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 % higher than those of the lowest - a difference of around £20 per account per year, or about 4 % 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****. (7.86) (Emboldening added).* These costs are in addition to the infrastructure costs and the costs to customers of switching and their costs of sorting out confusion and misbilling.

Margins are higher than with a regulated franchise. The Probe found regarding *net* margins that:-

> *Before customer acquisition costs net margins averaged almost 6 % over this period (8.7), which implies a net margin of about £16/customer in 2009) and that several companies cite a "through the cycle" supply margin of 5 % as an appropriate benchmark for the retail energy sector (8.6). 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. (1.17)* Since about half the customers remained in-area this implies that there was 5% surplus margin in the supply business compared with competitive (out of area) levels. By way of contrast, *in 1995, in the Monopolies and Mergers Commission report on Scottish Hydro, a margin on sales of 0.5 % was considered adequate for first tier monopoly electricity supply…In setting price controls in 1998, Offer and Ofgas considered a margin on sales of 1.5 % to adequately reflect the increased risks from the introduction of competition (8.19)*

British Gas's residential energy and supply margin for 2009 was 7.6%.

As noted in the previous chapter, Ofgem's Annual Report 2001-02 included the remarkable figure that the gross margin represented 30% of the electricity bill, which it confirmed at 28% in its 2004 Domestic Competitive Market Review. By way of contrast a study of retailing in Norway (where the typical residential customer consumes 20,000kWh p.a., compared with about 4000kWh p.a. in Britain) found that the mark-up of retail over wholesale price – the gross margin - ranged from 7-13% for fixed price products and 5-11% for the standard monthly variable price product. Although it is not appropriate to compare the percentages directly because there are economies of scale in the retailing business, the figures suggest either that the British margins are excessive and inefficient; or that retailing at the British scale is inherently expensive; or both.

In 1992/93 the average cost of supply (including profit margin) to customers below 100kW was £25, which (indexing by the RPI) is about £40 in 2004 prices; this gross margin represented 7% of the delivered price of electricity (excluding levies). Ofgem allowed a supply businesses cost per residential customer in 2000/01 of £35-42/customer (1998/99 prices) with a simple weighted average of £37.3, say about £50/customer in 2009 prices. The average gross margin for the years 2003-09 indexed to 2009 prices was £88[7]. We thus have the following estimates of gross margin of electricity supply/customer:-

	£(nominal)	£2009 prices (approx)
1992/93 (below 100kW)	25	40
2001	35-42 (98/99 prices)	(say) 50
2009	88	88

Although the 1992/93 cost figure is not directly comparable to the later ones because it includes all customers up to 100kW while the later two figures are for residential customers only, *it is clear from the foregoing figures that the costs and gross margins are now significantly higher than under the franchise. In part this is due to the "costs of competition" including the costs of sorting out data messes; in part to the higher net margins; and in part to higher administration costs such as the more sophisticated computer systems that are needed.*

ASSESSMENT

Although mass market retailing has resulted in some beneficial changes, notably the removal of the traditional rigid demarcation between gas and electricity which has led to savings, and introduced some innovations (for example in pricing structures and the move to payment by direct debit) these and other changes will have to be substantial in the future to offset the costs and the higher margins. Furthermore there is clear evidence that many customers have suffered inconvenience from mis-selling, mis-billing,and poor service.

[7] The sum was calculated from Ofgem's monthly series on gross margins in £/customer, price indexing to 2009 prices by the average annual RPI. The average margin in nominal prices was £81.5 and in 2009 prices was £87.8.

There is no evidence that residential customers – and the same is probably true for smaller business customers - have benefited financially from competition, and significant evidence to show that the costs of the infrastructure systems; the costs of competition; the costs of market power and the increase of net margin; and the widespread costs of flawed transfers, mis-selling, miss-billing, and misinformation have outweighed any benefits.

A fundamental reason for the lack of benefit is that residential consumption in Britain is modest at an average of 4000kWh p.a., representing in 2009 about £250 in energy costs together with the supply cost of about £75. In consequence competition is not worth the very significant transaction costs and the expensive infrastructure that has been developed. In contrast in Norway, where all dwellings are electrically heated and the average residential consumption is 16,000kWh p.a., and in Texas, where most dwellings have air conditioning and the average residential consumption is about 20,000kWh p.a., and where in both jurisdictions (for different reasons) there is currently a relatively fragmented and seemingly competitive supply industry, then competitive supply may be worthwhile.

One feature of supply that was not foreseen at the time when competition was introduced was the way in which the role of a supplier would be transmuted from a straightforward economic agent into an arm of government public policy, to which there have been two prongs. The first has been to subsidise the less well off in a way that was not entertained when the industry was nationalised – the electric industry was definitely not then regarded as a welfare agent; that was the role of welfare agencies. The second has been the way in which the suppliers have become stealth tax collectors for the government's green agenda.

In its leading article "It is time for a change in the balance of power" the Independent newspaper on 7 October 2009 wrote "Privatisation of the energy sector 20 years ago was intended to deliver great benefits to consumers. Out would go the monolithic nationalised industry and in would come a vibrant collection of competing independent providers. Competition would hold down prices and drive improvements in customer service. That was the theory. But it has not worked out like that in practice. The number of suppliers has fallen from more than 20 in the late 1990s to six dominant conglomerates today. Customer service is frequently poor. And, worst of all, there is compelling evidence that suppliers are overcharging their customers…Much more robust regulation of the sector is needed. The existing regulator, Ofgem, is frankly, not up to the job. It has persistently turned a blind eye to the abuses of the firms it is supposed to be overseeing declaring, despite all the evidence to the contrary, that the energy market is working well for consumers. And even when Ofgem does try to exert its authority, it is ignored."

Annex 6 THE ARRANGEMENTS IN NEW JERSEY

KEY POINTS

The population of New Jersey is 8.7 million and its area is 19,210 kms. There are four electric distribution companies (EDCs) - Public Service Electric and Gas Co (PSE&G), which serves nearly three quarters of the state's population; Jersey Central Power & Light Company, which serves a million electric customers; Atlantic City Electric, which serves more than ½ million electric customers; and Rockland Electric Company, which serves approximately 70,000 electric customers – they are all members and participants of the PJM electric market.

In 1998 the State Legislature passed the Electric Discount and Competition Act which required the four companies in the state to unbundle their generation from their electric distribution activities which included retail supply, and introduced competitive choice to all customers. Customers who did not switch would receive "Basic Generation Service" (BGS), which for the first three years to 31 July 2002 was specified in restructuring settlements that agreed in a package how the utilities would go forward and agreed network access rates, bundled rates, and other financial and non-financial matters. After that BGS would be provided in a competitive manner.

In 2001 the New Jersey Board of Public Utilities (the state regulator, referred hereafter as the Board) invited the EDCs to make a proposal on how to procure the power for BGS competitively. They proposed that there should be an auction to provide the BGS, and the Board agreed the approach. The EDCs appointed NERA as the auction manager.

The auction has evolved so that there are now separate auctions for 1) the load of smaller customers who are on profiles, and 2) for the load of sites who have interval meters (effectively those with a load in excess of 1MW):-

- The auction for the load of smaller customers is called the BGS Fixed Price (FP) Auction. The BGS load of each of the four EDCs is split into tranches of percentage shares representing about 100MW of full requirements service. A third of the load is offered each year in strips with a term of 3 years. Bidders bid a price in $/MWh that covers all of the costs of providing the service and the risks involved

- The auction for the load of the larger customer is called the BGS Commercial Industrial Energy Pricing (CIEP) Auction. The BGS load of each of the four EDCs is split into tranches of percentage shares representing about 25MW. Customers pay the PJM hourly spot price, and these are added to the costs of ancillary services, transmission and distribution are pre-determined. The bidder offers a price in

MW/day which covers 1) the capacity obligation, 2) the requirement to provide a fraction of green energy, and 3) the risk of migration of customers

In both auctions there are limits on how much one supplier is allowed to win, and there is a state-wide limit on how many tranches in total a supplier may win:-

- The EDCs contractually pass all retailing responsibilities except for billing and debt collection onto the winning suppliers who become the load serving entities registered with the PJM. The EDCs also transfer all risks associated with customers migrating to/from BGS. That has not been a significant risk for FP customers because only 10% have switched to competitive supply. In 2006 there was not a significant risk for CIEP customers when the limit was 1.25MW because although 85% have switched, most of them switched early on. In 2007 the limit was reduced from 1.25MW to 1MW, which introduced a risk of customers in the extended band switching

- The auction is a simultaneous, multiple round, descending clock auction, and proceeds in rounds which are run electronically. In a round, the Auction Manager announces a price for each EDC which can be different for each one. The auction is called “simultaneous” because tranches for all EDCs are offered through the same sale. Bidders bid by indicating the number of tranches that they are willing to serve for each EDC at the prices announced by the Auction Manager. If the number of tranches bid is greater than the number of tranches needed for an EDC, the price for that product is decremented for the next round, hence the name “descending”. Participants reduce the number of tranches they wish to serve as the prices decrease. Bidders are provided with the next round prices and a measure of excess supply remaining in the Auction, and are given an opportunity to bid again. The auction ends when the total number of tranches bid equals the number of tranches required by each EDC. The prices as the auction closes are the clearing or final auction prices. The suppliers that hold the final bids when the auction closes are the winning bidders

- The BGS-FP Auction began on 5 February 2006 and ended on 7 February 2006 after 22 rounds with the following closing prices for each EDC:-

	Closing price $/kWh	Total tranches available
Atlantic City	99.59	7
Jersey Central	99.64	15
PSE&G	98.88	28
Rockland	109.99	1

  Analysis of the auction by the Board’s adviser, Boston Pacific, concluded that by reference to several measures the FP auction was competitive, fair and transparent, and recommended the Board accept the result of the auction, which it did.

The BGS-CIEP Auction began on 2 February 2007, and ended on 6 February 2007 after 29 rounds with the following closing prices for each EDC:-

	Closing price	Total tranches

	$/MWday	secured
Atlantic City	135.61	23
Jersey Central	121.56	29
PSE&G	128.77	76
Rockland	153.31	2

Analysis of the auction again by Boston Pacific concluded that it was less competitive than the FP Auction but it was fair and transparent, and recommended the Board accept the result of the auction, which it did.

The number of winning bidders from 2002 to 2006 is as follows:-

Year	FP Auction	CIEP Auction	Across both auctions*
2002	n/a	n/a	15
2003	12	8	17
2004	10	6	14
2005	7	6	11
2006	10	3	12
2007	13	6	16

There has been a wide variety of bidder experiences over the five years. Some bidders have won tranches in all five years, while some have participated each year but have not always been among the winners, and others have not participated in all years. Some bidders who were winners of large numbers of tranches in 2002 have won smaller numbers in the subsequent years; others have followed the opposite trend.