ENERGY MARKET INVESTIGATION

Summary of hearing with Professor Stephen Littlechild, the former Director General of Electricity Supply and Head of the Office of Electricity Regulation, on 11 December 2014

Development of and concerns about the GB energy market

1. Professor Littlechild noted that he and four other former electricity regulators had provided a submission to the Competition and Markets Authority (CMA) in response to its issues statement. For many years the energy market in GB had been admired around the world and been considered to be very successful and active, yet it had now been referred to the CMA for a market investigation, and many people, including the present regulator, had said that there were a number of problems with the market. This raised the question of what had happened to the market over the past few years.

2. The former regulators had noted that the policy followed by Ofgem after 2008 varied significantly from that which they had pursued up to that point. They had asked that the CMA consider how these changes in policy after 2008, particularly the emphasis on social objectives and fair prices, had affected the market. Professor Littlechild's comments at the hearing reflected his own views and were not necessarily those of the other four former regulators.

3. Professor Littlechild’s view was that the issues included in the CMA’s first three theories of harm: barriers to entry, vertical integration, liquidity, market power, and profitability, did not seem to present problems for the GB energy market when viewed alongside other energy markets around the world. There were some matters which should be considered further, such as the cash-out mechanism and Ofgem’s liquidity requirements, but Ofgem had not indicated in the past that the issues in the first three theories were serious problems.

4. As for theories of harm 4(a) and 4(b) which referred to inactive customers and supplier behaviour, it was arguable that in every energy market around the world customers were inactive and suppliers offered complex or unclear tariffs, yet these were not issues which raised great concern in other countries, and up until 2008 the GB market had been regarded as one of the most active in the world. The real problems with the market had been caused by a number of regulatory interventions which had occurred since 2008.

5. It was likely that much of the public's and media's concern about energy prices could be explained by the fact that for about 20 years household energy prices had declined in real terms but during the following ten years there had been a sharp increase in prices followed by a period during which prices had behaved erratically. These changes in energy prices had coincided with the financial crisis and consequent concerns about employment and incomes, and to many people, who found it harder to pay their energy bills, it appeared that something had gone wrong with the market. The increases in GB domestic energy prices had in fact been largely caused by increases in international fuel prices and new environmental regulations, but this had not been made entirely clear to the public by Ofgem or the Government, so many people suspected that the energy companies were responsible for the price increases and this had led to a lack of trust in the market. The lack of trust was a problem, but it was not one caused by a lack of competition in the market.

The retail market

6. Since 2008 Ofgem had perceived the retail market as problematic. It considered that suppliers were setting prices which were too complex and that customers were failing to understand suppliers' prices and consequently not engaging in the market. Ofgem's solution to these problems had been to try to get both suppliers and customers to behave properly through a combination of requiring suppliers to provide simpler tariffs and encouraging and enabling customers to compare prices. Once suppliers' and customers' behaviour had adjusted, then Ofgem would look to reduce the regulation of the market.

7. Professor Littlechild's view was that Ofgem's perception that the market was problematic had been misconceived, and that its interventions, in particular, the non-discrimination licensing condition and the rules limiting the number and variety of retail tariffs (the Retail Market Reforms (RMR)), had made and continued to make the situation worse rather than better in that they were reducing competition and harming consumers. Competition was a rivalrous discovery process taking place over time. Competition was not a state of perfectly informed customers all paying the same price for the same product.

8. Ofgem's policies had not prevented all competition between companies, but they had distorted competition, and these distortions had led to the companies trying to find other ways to compete, so for example the non-discrimination policy had led to the suppliers trying to continue competition by offering a wide range of fixed tariffs. This had led to Ofgem becoming concerned about the number of tariffs on offer, which had led to restrictions on the number and types of tariffs, eg effectively requiring all tariffs to have a standing charge (by

disallowing multiple unit rates). This had had the effect of Ofgem imposing its view as to what were appropriate forms of competition rather than allowing suppliers to find out what consumers actually wanted in terms of tariffs and payment arrangements. The four-tariff limit had reinforced the other restrictions and made it more difficult for suppliers to innovate and address customers' needs.

9. By restricting suppliers' ability to compete Ofgem had potentially made it easier for them to coordinate as there were now fewer ways for them to compete, and they would be better able to monitor each other's offers.

10. Up to this point, Ofgem's interventions had not produced any customer benefits which might offset their negative effects on competition. Lower prices had not been achieved. The RMR tariff restrictions had removed some types of discounts, and it was arguable that the non-discrimination condition had led to around £1 billion higher supplier profits. The RMR had also restricted consumer choice and suppliers' ability to innovate. Consumer engagement had also declined since the start of these policies, and there was no evidence that it would increase in the future as a result of them. Consumers were attracted to engage in the market by the prospect of making significant savings or by other offers such as 'free gifts'. Simple tariffs which did not allow for innovation in the way that complex tariffs did were less attractive to customers.

11. Ofgem had a primary duty to protect the interests of consumers wherever appropriate by promoting competition, and in carrying out this duty it had to take into account a number of other secondary duties, such as protecting vulnerable consumers, contributing to sustainable development and having regard to Government guidance. Ofgem also had a duty, like other regulators, to act consistently and proportionately.

12. Ofgem's interventions did not appear to meet the requirements of its primary duty to protect consumers and promote competition. Ofgem's own assumption was that its non-discrimination licence condition would make some customers approximately £0.5 billion a year better off but others £0.5 billion a year worse off to retain a neutral position with respect to suppliers, and in the event customers in total appeared to be about £1 billion a year worse off. And competition had been restricted rather than promoted. But if the policies were not meeting the primary duty, were they a sound basis for pursuing a secondary duty? It appeared that concerns about vulnerable customers, which were a defined category of customers in the Act, had been conflated with concerns about less engaged customers. This had led to the idea of 'fairness' where it was felt to be wrong that vulnerable and less engaged customers did not obtain the same prices as less vulnerable or more engaged

customers. But this posed a fundamental difficulty for the promotion of competition because, from this perspective, competition was not the solution to a problem but a problem in itself. In a competitive market innovation would continually create new types of tariffs, new pricing models, and new offers designed to attract different types of consumer. Naturally, the most engaged consumers would be the ones who responded to new offers first, and they would receive better deals, including better prices, than less engaged consumers. So Ofgem's policy was not leading to a restriction of competition as an unintended consequence, it was of the essence of that policy that it should restrict competition in order to eliminate differences in prices.

13. It was not only questionable whether Ofgem's policy was consistent with its statutory duties, it also did not seem to be in the interests of vulnerable customers in particular. Supplier profits had increased and tariffs which vulnerable customers valued had been restricted. Nor was this a proportionate policy. The possible benefits were long-term, hypothetical, unlikely to come about, somewhat intangible and indirect, whereas the costs were immediate, real and substantial. Nor was the policy consistent with previous regulatory policy. Vulnerable customers were a matter of concern, but they were best served by competition, and by other steps such as collective switching and by making it easier for switching sites to reach out to these consumers and assist them in switching.

14. In answer to questions, Professor Littlechild said that, although any particular commodity was arguably unlike any other commodity, there was a political concern when energy prices rose. This was an understandable concern, but it was important to explain that prices could go up as well as down in a competitive market. The competitive market process as a discovery mechanism was better placed to find out the best way for consumers to handle uncertain and possibly rising prices than for Ofgem to prescribe the way.

15. In considering what characteristics a 'well-functioning' energy market would have, the CMA should avoid being tempted into trying to describe what it felt it would be nice to have without any regard to how markets actually worked and whether this was realistic. Attempting to specify how the market ought to work might not be realistic and might have worse consequences.

16. Whilst excess profitability was a possible indicator that the market might not be working well, there were various reasons why firms in a given market might be making too much money, and a market might not be working well even if they were not making too much money. If the firms in a market were too profitable one would expect new entry. There had been new entry to the energy market since 2008, in response to the increase in incumbent suppliers' profits following the Ofgem restrictions, and this was evidence that the market

was working. Professor Littlechild did not know whether the companies which had entered the energy market since 2008 would be able to survive if the constraints on competition were removed, and if the less burdensome regulatory arrangements for smaller suppliers (those with fewer than a certain number of customers) were changed, but he thought they had been sufficiently innovative and lower cost that they would survive.

17. There were a number of examples of ‘well-functioning’ markets which could be used as a comparator for the current GB energy market including the pre-2008 GB market, and the markets in Victoria, Australia, and in Texas in the USA. These markets lacked the sort of regulatory interventions which characterised the current GB market and were vibrant.

18. In looking to strike a balance between competition and regulation in the energy market, it was necessary to consider any regulatory intervention or restriction of competition against Ofgem’s primary duties of protecting consumers and promoting competition.

19. Professor Littlechild did not know whether the ‘rocket and feather’ phenomenon regarding the raising and lowering of retail prices was actually happening – Ofgem’s analyses had varied over time – but empirical analysis by Peltzman had shown that this phenomenon did not appear to be linked to market power, and it would be minimal in terms of its overall impact on market prices over the last 15 years.

20. The fact that some energy suppliers would be more or less efficient than their competitors was not surprising and was not necessarily a sign of the presence of latent monopolies. There would always be cost and efficiency differences between firms in any market, and particularly in one like energy, where the industry had been privatised and the incumbent suppliers had old legacy systems which were clunky and inefficient. These sorts of costs could only be reduced gradually. New entrants could design and obtain up-to-date systems which met their needs and ambitions for obtaining new customers. Up until about 2008, energy companies were making very little money or were even incurring losses on their supply businesses, so it was unlikely that they were not trying to reduce any excess costs.

21. If Ofgem's various restrictions were removed, then, given how the incumbent suppliers had tried to find new ways to compete in the wake of Ofgem’s initial restrictions, and given that new suppliers now accounted for 9% of the market and growing, it was likely that the incumbent suppliers would once again compete more fiercely with each other than they did currently.

22. As to whether, if Ofgem's measures were abolished, small suppliers would be able to compete against vertically integrated operators, whether vertical integration conferred an efficiency benefit, and whether it was the CMA's task to ensure competition among the incumbents or secure a different mix of players in the market, it was not the CMA's task to decide on the appropriate number and types of competitors but to put in place conditions for the most efficient companies to enter and survive in the market. As a regulator Professor Littlechild had not known whether vertical integration would be more efficient: he wanted to learn this from the market. Until recently it seemed that vertical integration was not necessary in the business market but it was an advantage in the domestic market. One major incumbent supplier had recently decided to de-integrate its generation and supply businesses because it felt it was no longer critical for it to minimise its risks in this way. The growth of a number of the new suppliers suggested that if vertical integration had been a significant barrier to entry in the past, it was now less so.

23. It was quite striking how Ofgem suddenly discovered a new way of characterising customers in 2008. The increasing number of customers alleged to be 'sticky' was also surprising. Nearly 65% of customers were now with a non-home supplier and a good proportion of the remaining 35% had moved and returned to their original supplier, so the total number of customers who had never changed supplier was perhaps between 15 and 20%. Many of these customers would have decided that the gains they might achieve by switching were not worth the hassle of doing so. The number of customers who were seriously concerned by their energy costs but were afraid to switch was probably a small percentage.

24. Many 'sticky' energy customers did not want to spend a lot of time searching for better tariffs and switching. In this sense, they were similar to customers in all other markets. If companies tried to exploit 'sticky' customers by raising prices, they would find it hard to do so without raising prices to more active customers that they might lose, and their rivals would be encouraged to offer better deals to attract these customers. If the aim was to protect consumers by encouraging them to engage in the market, suppliers and switching sites knew better how to do that than Ofgem did.

25. It was not a credible strategy for a supplier to try to create confusion in the market in order to discourage customers from switching. Suppliers tried to attract customers by analysing the market and developing new and different offers which were tailored to appeal to different groups of customers. Customers had a range of different needs, and suppliers designed tariffs to meet these. Because the offers were tailored very carefully to appeal to particular sets of customers, that was why there were a lot of tariffs. It was naive to think that making tariffs simpler would facilitate competition:

nowadays most consumers used price comparison websites (PCWs) to find a better deal rather than tried to compare a set of different tariffs themselves. Consumers were encouraged to switch, not by simpler tariffs, but by suppliers and PCWs offering them deals which were significantly better than the ones they had. These did not always have to be the best available deal for competition to work effectively.

26. In the USA, municipally organised collective switching schemes which required customers to ‘opt-out’ of the collective switch had been successful in some areas. In the USA, these schemes had been implemented in areas where there was little or no retail competition, which was very different from the GB market. Also, collective switching schemes of this type did not allow for the tailoring of offers to different types of customers in the way that a vibrant retail market would. There was perhaps some scope for opt-out switching schemes in organisations such as housing associations, which could bring some disengaged and vulnerable customers into the market.

27. The main adverse effect from Ofgem’s non-discrimination licence condition had been the prevention of regional price discrimination (ie in-area vs out-of-area price differentials). With respect to prohibitions on discriminating on payment type there were two additional considerations: a European Directive and an argument by some economists that the adverse effect on competition did not apply, though Professor Littlechild had not seen evidence on that.

28. As to what could be inferred if it were found that customers could achieve substantial savings by switching from standard variable tariffs to other tariffs, it seemed that, by restricting competition on standard variable tariffs, partly through the non-discrimination licence condition, and partly by defining companies’ ‘best’ tariffs to be standard variable ones rather than fixed ones, Ofgem had created a strong distinction between the standard variable and fixed tariffs. Requiring suppliers to put customers on their ‘best’ standard variable tariff introduced an incentive to get rid of the cheaper variable tariffs and to put customers on to as a high a tariff as possible. The suppliers now competed with each other on fixed-rate tariffs. This was an example of Ofgem trying to solve one problem but creating another in the process and then trying to address that with another restriction.

29. The growth in fixed-term tariffs had been in part a result of the prohibition on regional price discrimination on standard variable tariffs. Although this restriction had officially lapsed, suppliers were still adhering to it and said that they were doing so because Ofgem had warned them that if they did price discriminate on a regional basis it would take action. As to what might be the effect if Ofgem were to make it clear that it would not take action, such a

statement would not be entirely credible unless the CMA had already given its view and Ofgem's position was in line with that.

30. It was not plausible that the reduction in switching rates since 2008 was a consequence of the increase in the number of tariffs. The reduction in switching rates was more likely to have been a consequence of the prohibition of regional price discrimination. A 12-month moving average of switching rates showed a number of significant declines in switching after 2008 which coincided with Ofgem’s policies.

31. The end of doorstep selling seemed to have led to a further decline in switching rates, but it came after the start of the overall decline. Doorstep selling, as then practised, was not a sales method that customers, suppliers or the regulator were happy with. However, it might be worth looking at whether there was a way that doorstep selling could be managed so that it could be made acceptable. At least one supplier currently used direct approach marketing in order to attract customers, and they were some of the most vulnerable types of customers and primarily on pre-payment meters. Approaches such as this appeared to be a viable way of marketing to hard-to-reach customers, so the challenge was to do that in a way that was acceptable to those customers. Professor Littlechild offered to give further thought to the question where and what kind of regulation would be appropriate for doorstep selling and related marketing activities.

32. The tariff simplification measures introduced by the RMR had negatively affected competition by limiting the scope for suppliers to differentiate their retail offers. If every tariff had the same structure and the same standing charge, then the only element which suppliers could compete on would be the unit charge. That would almost be the perfect condition for coordination of suppliers’ activities, and it would be likely that any differences between suppliers’ unit charges would be very small, so prices would be very similar, consumers would not consider it to be worth their while to switch and there would be less customer engagement and competitive pressure.

33. As to how to deal with political pressure to intervene in the market, it was necessary first to understand how the market operated and what policy would be appropriate, and then to consider how best that could be explained and presented, including to Government. This would include explaining why a competitive market was actually in the best interests of all consumers, including vulnerable ones, and that the main problems with the market (notably rising prices) had come from outside.

34. In practice, in markets around the world the more competitive a market was the higher the switching rate would be. Prior to 2008, switching rates in the

GB market were around 20% a year, which was among the highest in the world. Current levels of switching in GB, which were around 10%, indicated that the market was not currently allowed to operate as freely as it had before, not that customers were more satisfied.

35. PCWs, along with the rest of the market and Ofgem, were all trying to find out what motivated consumers and how they found it most interesting and attractive to have information presented to them. To discover this it was necessary to allow a wide range of approaches to be tried rather than have the regulator mandate a format. A single uniform way of ranking all the options available was unattainable and undesirable. The realistic aim was to make consumers aware of when they could achieve significant savings so they could decide when it was worthwhile switching tariffs, but this switch did not always have to be to the best tariff available.

36. The requirement that switching sites listed all tariffs even if the supplier did not pay a commission was a difficult issue. There would not be a strong objection to PCWs being required to show all tariffs available on the market. There would be a case for making it clear to customers which tariffs they would be able to switch to via the PCW they were viewing and which tariffs were not available for switching from that site. However, the regulatory obligations should not prevent the PCWs from continuing to exist. The PCW market in GB seemed to be the best in the world, in terms of number and variety of switching sites, partly because the regulator itself had not provided a switching site and had not specified precisely what switching sites must do, and instead had left it to the market. PCWs had to get their revenue from somewhere, but it would be possible to be clearer to customers that the offers they could switch to from a PCW were not necessarily the best ones without interfering too much in the market.

37. It was not clear what the impact of smart meters on customer engagement would be. The more it was left to suppliers to explore the market, the more would be learned. The current four-tariff policy and other restrictions put in place by the RMR were absolutely inconsistent with a market with smart meters. It was therefore necessary to change the policy before smart meters arrived.

38. Two of the Government's objectives for the energy market were to have low, competitive prices and to meet social and environmental objectives. The Government had put in place a variety of measures to address social and environmental issues, and it was not clear why it was necessary for Ofgem to take further steps to meet these objectives through retail regulation.

39. The question of whether people trusted their energy suppliers or had trust in the energy sector as a whole was a recent one. Most people had not thought about it before, and the concept of trust in the energy market was rather subjective. It was important to look at what people did rather than what they said.

40. As to why there were not similar calls for the regulation of the retail petrol industry despite the fact that the complaints about the energy market and the retail petrol market were of a similar nature, eg ‘rocket and feather’ price movements, this might have been in part because the energy industry had been privatised relatively recently and there was still some antipathy against that, and partly because the existence of a regulatory body for energy encouraged the view that it could and ought to do something.

The wholesale market

41. The GB wholesale market could have been designed to allow for greater liquidity in last-minute trading. The dual cash-out policy had militated against this. If the market design gave buyers and sellers greater incentive and ability to balance the market; then the system operator’s role in balancing could be reduced. It was possible that the dual cash-out mechanism had been a spur to vertical integration but whether this actually was the case was unknown, and it was unlikely to have been the determining factor in the actual extent of vertical integration.

42. The proposed move to a single cash-out price was sensible because it would eliminate a distortion. However, the decision to go directly from the current PAR 500 basis to a PAR 1 basis seemed a massive change. Professor Littlechild did not know how many bids currently went into defining the PAR 500 price, but it was likely to be fewer, maybe even only one bid, which would determine the PAR 1 price. If this was the case, then suppliers could be open to accusations of manipulation. It would be preferable to go from PAR 500 to, say, PAR 100 in the first instance, see how it worked, then move in a more gradual progression if that seemed sensible.

43. As to whether the introduction of locational pricing, including for losses, would improve the market, OFFER’s approach in the 1990s had been a pragmatic one: there was an argument that it would have improved the efficiency of the GB market, but its introduction would have led to much higher energy prices at particular spots in the network, and this would have been highly controversial politically. The market already generated a reasonable amount of price signals from zonal pricing, and there seemed more important issues to pursue. Since then the smoothing of prices had gone in the opposite

direction, encouraging wind generation where there was wind rather than where there was demand, so the incentives were now perverse.

44. Concerns had been raised that wholesale prices were opaque, and it had been suggested that a system which produced a transparent and verifiable spot price should be set up. Professor Littlechild's view was that the alleged opaqueness of prices was not really a problem. Anyone who was interested in buying or selling power in the wholesale market, including new entrants, knew what prices were. Smaller market participants might not like the price, and might prefer a uniform price independent of quantity traded, but they all knew the price. While there might be some merit in having a publicly quoted energy price, it might reduce flexibility, and reporting of prices was not always easy. The lack of a transparent wholesale price was not a problem for constructing index-linked products, since other indexes were available. Having a public price based on an explicit index might increase the likelihood of the price being manipulated. Under the current system, buyers and sellers of energy were negotiating on their own behalf and were incentivised to get the best prices they could and not to be misled.