Response to Ofgem Energy Probe Consultation: December 2008

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Ofgem's clear and thorough analysis of the retail energy sector, addressing questions which have been causing concern amongst politicians and commentators, is very welcome. It provides an excellent opportunity for the Regulator and the Government to consider the proposed remedies with equal thoroughness and, in particular, not to rush into implementing remedies which might produce perverse unintended consequences.

Actions 1 to 4 are all aimed at making competition work more effectively, while Action 5 provides direct constraints on the behaviour of the energy retailers. In general, applying any direct controls in liberalised markets is likely to distort the competitive process in ways that are often difficult to foresee. In particular, social objectives cannot be delivered through markets without distorting outcomes, and there are much more efficient ways of delivering these directly. If the government and regulator insist on using energy markets to deliver such objectives, a more formally regulated energy market might be less distortionary than a liberalised market subject to regulatory 'manipulation'. This response comments in more detail on several of the suggested remedies, particularly as they affect the retail market, drawing on relevant research at the Centre for Competition Policy.

Action 1: promoting more consumer engagement

Clearer information on bills and an annual statement providing information which may prompt a consumer to consider switching are welcome. This will bring energy into line with services such as car insurance, where it seems that the annual reminder prompts a higher switching rate (Chang and Waddams Price, 2008, CW). If the date of the reminder is known to competitors, it may also encourage direct marketing just beforehand, as undertaken by insurers in similar situations. It may be useful to give information in the reminder about how best to compare all the available offers, so that any direct approaches from alternative suppliers can be assessed against this broader information about opportunities in the market.

Confidence in their own estimates of potential gains from switching seems to be important in determining consumer action in the market (CWP), so the objective of ***increasing confidence in switching sites*** is important. When the Centre for Competition Policy held 'switching surgeries' for consumers in March and August 2008, the majority of the 200 or so attendees arrived having undertaken thorough, and generally accurate, research about cheaper deals; but they were sufficiently doubtful about their findings to go to considerable trouble to seek independent advice. Most information obtained by these consumers was from the internet, sometimes through family members who had better access or confidence in using the internet than the consumers themselves. There was widespread doubt amongst these consumers[2] about

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[2] The consumers who attended these advice surgeries were clearly not a representative group, but their experience sheds some light on the difficulties and anxieties which energy users face.

the credibility they should attach to the findings. In some cases such doubts were confirmed by checking across two different websites, both leading comparison websites which had received the energywatch confidence code approval, but which indicated significantly different best buys and savings.

There is a tension inherent in the incentives of commercial websites, which are to highlight particular deals for consumers which will render rewards for the website if the consumer switches. The comparison website may be reluctant to identify offers by energy retailers who do not pay it for direct switching, although it is a requirement of the confidence code to include all available opportunities. More recently, retailers themselves have restricted the number of offers to which consumers can switch directly through any website, particularly, but not only, for prepayment. To address the issue of the websites' incentives, it may be more appropriate to consider either a publicly provided website (as, for example, some US and Australian States and Canadian provinces provide) or to regulate the activities of the commercial websites directly. In the UK the Competition Commission has recently established an independent regulator, as part of its remedies for the Home Credit Market (Competition Commission, 2006).

Clearly public provision or regulation imposes cost on the public purse, but the benefits may outweigh these costs. Evidence from many studies (including CW) shows that consumers who switch in one market are more likely to do so in others. This result persists even after accounting for variation in consumer characteristics, indicating that switching once does encourage other switching, rather than that some consumers are merely inherently predisposed to switching. These positive externalities across markets provide an argument for public funding of comparison sites by the taxpayer rather than by the consumers in any one market.

While public provision of comparative information may increase consumers' confidence in websites, this will be of little help if they are unaware of their existence. Commercial websites have been competing strongly with each other and have invested in large scale public advertising campaigns. A publicly provided website would need to meet advertising as well as operational costs, though regulation of privately owned sites would not necessarily imply public subsidy of advertising.

The ***consumer awareness programme*** is particularly welcome. In advising consumers we have found it particularly difficult to identify social tariffs which might be available to vulnerable consumers. This is unsurprising since energy retailers have little incentive to advertise tariffs which they have introduced under government and regulatory pressure and which, by definition, are less profitable than their other offers.

Social tariffs are unlikely to be the best way to help low income energy consumers: like any subsidy scheme it is likely to suffer from errors both of inclusion and exclusion, and introduces distortions into a market which is designed to be competitive. However if this is the government policy, and there is no other assistance for those struggling with increased energy bills, it is important that the help is accessed by the appropriate potential beneficiaries. The government has set some expenditure targets for companies' social programmes, which could lead to some odd distortions in attempts to meet these targets. To avoid these and ensure that benefits are appropriately disbursed, the regulator might consider setting targets for awareness within potential recipient groups and their advisers, to ensure that the companies are advertising their social tariffs adequately. A publicly funded comparison website (or addendum to a private website) would seem particularly pertinent in this context, and assist in delivering appropriate benefits to those consumers most in need.

Action 2: Helping Consumers make well informed choices

The proposal for implementing an ***easy- to- understand price metric*** is welcome, and there are some lessons to be learnt from similar moves in other industries (for example mandatory declaration of APR in financial services). Our research (Wilson and Waddams Price, 2007, WW) shows, like Ofgem's own study, that many consumers not only fail to choose the best tariff for them (which can be explained by search costs); but that between a fifth and a third actually choose more expensive suppliers, even when their sole objective in switching was to save money. Moreover there seems to be little evidence of 'learning'; consumers in 2005 seemed to choose no better than those interviewed in 2000, at the very beginning of market opening; and those switching for a second or subsequent time did not make more savings than those switching for the first time. (This is less surprising because the initial switches away from the incumbents provide substantial benefits, so there are generally fewer gains *available* at subsequent switching.) Although energy is intrinsically simpler than financial products, there is still scope for a straight per therm measure to be used in a misleading way, particularly for low consumption consumers for whom a large proportion of supply costs are consumer rather than therm related. There is also a danger that other dimensions of energy service which are important to consumers are neglected because of the focus on the single metric.

One problem of interpreting a per therm comparison and of using price comparison websites, is that consumers seem to have a distorted idea of their own consumption levels. Where we were able to compare consumer estimates of expenditure with company records we found a persistent bias towards the mean consumption level: consumers whose company records showed that they used low amounts of energy tended to overestimate their consumption, while those who used above average quantities underestimated (Mathieu and Waddams Price, 2004). These errors were common across energy, but varied somewhat between gas and electricity and for different payment methods. Similar problems in using consumer estimates in expenditure surveys were identified by Pudney, 2008. Understanding this bias is important in designing appropriate remedies, and Ofgem would be in an excellent position to undertake further research matching consumer estimates to company records and updating and exploring the findings of MW.

Protection against misleading sales and marketing activities is already provided under consumer protection law, so identifying opportunities for more rigorous enforcement would be a good first step towards any extension of powers in this area.

Action 3: reducing barriers to entry and expansion

The vertical integration of the 'Big 6' seems to provide considerable advantages, and the proposed measures under this heading are welcome. There is an inevitable trade-off between protecting consumers through regulatory obligations, and encouraging entry by reducing such obligations.

Separation of generation and supply accounts would provide more transparency, but any cost of this activity needs to be balanced against the information it can provide, given the inevitable degree of arbitrariness inherent in such an activity (which has caused Ofgem such difficulty in analysing retail margins).

Further analysis of how far tariff structure has been used to soften competition would be likely to provide important information on market competitiveness. Analysis of the evolution of tariff structure since the deregulation of the market suggests that these may have been an instrument which has enabled the Big 6 to avoid head to head competition (Davies, Waddams Price and Wilson, DWW, 2008). While it is difficult to envisage a remedy which would restrict tariff structures other than a cap on each tariff element (which would be even more restrictive and potentially distortionary than that which applied before competition was introduced to the market), further analysis by Ofgem, with the benefit of detailed data, including regional market shares, which are not publicly available, would provide insight into the extent to which tariff structures had softened competition, and could inform the development of appropriate remedies. It would also throw more light on the advantages enjoyed by incumbent firms whose prices are higher than entrants', even though marginal (and average) costs are likely to be lower (Salies and Waddams Price, 2004, updated in Akman, Harker and Waddams Price, 2007; and DWW).

Action 5: Addressing concerns over unfair price differentials

The remedies in this section run the risk of introducing considerable distortions into the market, and even of producing perverse effects of raising prepayment prices above the level which the competitive market might deliver. Since the evolution of tariff structure in a competitive market is not well understood in theory, either in terms of standing charge vs running rate, or across different consumer types with varying costs and demand characteristics, it is difficult to compare outcomes with a 'model benchmark'. However it is unlikely that a competitive outcome for a product where average costs exceed marginal costs[3] would entail proportional mark-ups across all consumer types and tariff elements. Indeed given that prepayment consumers are likely in general to have more price elastic demand than those using other payment methods (because they have lower average income), a competitive outcome would probably deliver lower mark-ups for these consumers. This outcome would mirror that of both a profit maximising monopolist and a monopolist who is constrained to deliver the market welfare maximising price structure.

The imposition of a requirement for ***cost reflective tariffs*** seems inconsistent with a market where the regulator is placing the onus on competition to discipline supplier prices. Forcing cost reflectivity might actually raise prepayment prices above those which would emerge from a competitive market.

A prohibition on undue price discrimination, mirroring the duties of the companies before liberalisation and under more recent competition law to the extent that they remain dominant, might be a useful general guideline. Given that Chapter 2 of the

[3] This pattern seems to characterise retail energy supply, where there are fixed costs of computer systems and marketing

Competition Act prohibits similar abuse of a *dominant* position, inserting such a clause effectively removes the requirement on regulatory authorities to demonstrate that the firms are dominant - perhaps this might be interpreted as recognition that they are in some sense ‘jointly dominant’. However even without the need to prove dominance, considerable practical difficulties in implementing Chapter 2 have become clear. Experience from attempting to enforce the earlier prohibition on undue discrimination where the regulator determined that there was discrimination but it was not ‘undue’ (Ofgas, 1998 and discussion in Otero and Waddams Price 2001) illustrate the practical challenges. Nevertheless this very uncertainty might provide some constraint against egregious overpricing in some markets, though it has already been noted that it could operate against the interests of prepayment consumers.

A formal ***relative price control*** is likely to compound the drawbacks of the proportionality and price discrimination remedies discussed above. Intuition suggests that if, for example, prepayment prices are controlled in relation to the price charged to direct debit consumers, whether by an absolute or a proportional amount, prices for direct debit customers will be higher than those which the firm would otherwise choose, in the presence of any degree of market power (i.e. unless the market is perfectly competitive). Such intuition can be confirmed through formal economic modelling. Since these remedies are clearly designed to control some element of market power on the part of the companies, perfect competition does not prevail, and so a relative price control would, indeed, drive up direct debit prices. This is clearly not efficient, in terms of giving consumers appropriate messages about the relative costs of different payment methods, let alone energy consumption. And it may not be desirably distributionally, since although the average income of prepayment meter users is lower than that of direct debit payers, there is not a perfect relationship between income and payment method, and a large number of direct debit and standard credit payers are in lower income groups.

Moreover even if such price rebalancing and distortion is avoided, the marginal returns to companies of prepayment consumers will fall relative to other customers, perhaps initiating a return to the situation observed when the market first opened, with companies trying to avoid recruiting prepayment customers and so depriving them of the benefits of choice which the liberalised market can offer. Given the scope for distortion and unintended consequences, a relative price cap is unlikely to remedy concerns over prepayment meter tariffs in a proportionate manner.

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