

Ofgem: Developing a framework for assessing whether conditions are in place for effective competition in domestic supply contracts

Consultation response from the Centre for Competition Policy

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This response is in two parts. Part 1 broadly addresses questions 1 to 5 in the Discussion Paper; Part 2 focuses on the concept of Transactional Unfairness and its relevance to the issues raised in the Discussion Paper.

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Part 1: Responses to questions 1 to 5

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Part 2: Transactional Unfairness and Price Discrimination

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This consultation response has been drafted by the named academic members of the Centre, who retain responsibility for the section of content to which their name is attached.

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Centre for Competition policy response to Ofgem’s Discussion Paper ‘Developing a framework for assessing whether conditions are in place for effective competition in domestic supply contracts

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Part 1: Responses to questions 1 to 5

(Authors: Dr David Deller and Prof Catherine Waddams)

Question 1: Are there any features of effective competition that are not covered in our definition?

The fundamental question underlying the concept of effective competition is ‘effective for whom?’ Much of the recent criticism and unease with the competitive process arises out of a suspicion that it delivers good outcomes only for a privileged few. We welcome the distinction between process and outcome, as emphasized in our own research on Fairness in Retail Energy¹ and response to the BEIS consultation on the introduction of the price cap² and the focus on good (rather than the best possible) outcome. Despite recent challenges around its use, competition is a powerful tool if used appropriately to deliver for most consumers. It effectively aggregates diverse consumer preferences, while not necessarily delivering good outcomes for all; we agree that protection for some may be necessary, particularly in a sector which provides such an essential product and which is so politically salient. Since the price cap was introduced as a (cross party) political action, assessing its removal is likely to be similarly a largely political decision.

As one of the principles, Ofgem cites the importance of transparency in its own process, and we emphasise the importance of similar transparency in the offers of providers in the market (see part 2 below).

The broad division of conditions into structural, competitive process and good outcomes seems intuitively attractive, but it may in practice prove more difficult to separate the different parts. For example, more co-ordination between suppliers to protect consumers in vulnerable situations as suggested under good outcomes, may lead to opportunities for co-ordinated effects which might need to be addressed under structural changes. The silos will

¹ David Deller and Catherine Waddams Price (editors) (2018), ‘Fairness in Retail Energy Markets? Evidence from the UK’, A report by the Centre for Competition Policy, available at:

<https://lred.uea.ac.uk/documents/8158338/18232983/CCP+%26+UKERC+-+Fairness+in+Retail+Energy+Markets+Report.pdf/6499c409-10c9-8f5a-73a3-0290b5ab022f>

² David Deller, Elizabeth Errington, Amelia Fletcher, Morten Hviid, David Reader and Catherine Waddams (2017) consultation response to Business, Energy and Industrial Strategy Committee: Pre-legislative scrutiny of the draft Domestic Gas and Electricity (Tariff Cap) Bill inquiry, December 2017, available at:

<http://competitionpolicy.ac.uk/documents/8158338/16525214/6+CCP+response+to+BEIS+Committee+Energy+Price+Cap+Inquiry.pdf/236d419d-d157-2e0e-2eea-0923d75dd035>

need to be considered in terms of how they work together, as well as separately, in assessing the effectiveness of competition.

In applying concepts of effective competition, Ofgem might wish to explore the Competition Commission's development of the concept of well-functioning markets, and the associated discussion, particularly as it applied to energy, see for example contributions in the European Competition Journal³. While this concept was developed mainly for markets in which there were intrinsic limits to competition, it has obvious similarities to that of effective competition.

In section 3.10, the second bullet refers to consumer outcomes including both prices and price differentials, with the implication that consumers prefer low levels of both. Price differentials have played a major part in energy market deliberations, and their proscription in 2009 resulted in less effective competition⁴. There may then be some trade off between lower prices and narrower price differentials.

Question 2: What are your views on the conditions for effective competition we have proposed? Are they clear and is there anything else you think we should take into account?

Condition 3: At 3.12, condition 3 states that 'competition is expected to deliver good outcomes for most consumers', which differs subtly from the pillar on good outcomes on page 13 which refers to the competitive process being '**capable of** delivering good outcomes for most consumers' (our emphasis). Both statements explicitly include 'those who are less active in the market'. The first condition could arguably be met through the process which **could** yield a particular outcome, the second seems to imply that the good outcome must be realised. Given the central role of the less active as both instigators and targets of the introduction of the price cap, this apparent hair splitting may be important in assessing effective competition, so that resolving ambiguity would be helpful in developing the framework.

The distinction between providing the conditions for good outcomes and their realisation lies at the heart of much of this intervention and the framework which Ofgem is required to develop. It raises the question of the relative importance of a competitive process and the outcomes which it generates in practice. For example, If consumers remain 'inactive' and this is not due to their preference for their existing supplier, the competitive process may be working satisfactorily, but the conditions for good outcomes are still not in place. While regulation has traditionally been concerned with the process, outcomes are more likely to be relevant to the general public and provide greater political salience.

The framework refers to good outcomes for the less active in the market, but it is unclear how 'good' is defined. Is it relative to outcomes for active customers? This interpretation could

³ Morten Hviid and Catherine Waddams Price (2014), 'Well-functioning markets in retail energy', European Competition Journal, 10(1), pp. 167-179; Stephen Littlechild (2014), 'The Competition Assessment Framework for the Retail Energy Sector: Some Concerns about the Proposed Interpretation', European Competition Journal, 10(1), pp. 181-202

⁴ Morten Hviid and Catherine Waddams Price (2012), 'Non-discrimination clauses in the retail energy sector', The Economic Journal, 122, pp. F236-252; and Catherine Waddams Price and Minyan Zhu (2016), 'Non-discrimination clauses: their effect on GB Retail Energy Prices 2005-2013', The Energy Journal, 37(2), pp. 111-132

result in incentives for providers which reduce the overall benefits in the market. Or is it good relative to a different organisation of the market? This captures a choice between maximising total consumer welfare in the market and its distribution amongst different consumers, and how far this should be determined by activity and need.

Condition 2 (paragraph 3.19 first bullet) raises the issue of failing firms, which provides a specific example of the potential tension between process and outcome. Effective competition inevitably includes the possibility of exit from the market (in order to be able to accommodate entry and innovation), and this process will sometimes entail costs which have to be recovered from consumers. The right balance between restricting entry through rules which encourage sustainable business models and reducing entry barriers is an operational one which the regulator seems well placed to determine. Over the past few years the regulator has relaxed entry conditions to reduce barriers to entry, and is now seeking to reintroduce some of the conditions to ensure sustainable business models. There will inevitably be special pleading on behalf both of potential entrants and exiters, which should be assessed on their merits rather than their political influence.

The third bullet of 3.19 emphasises the importance of consumer information, which is addressed in part 2 below.

Condition 3 refers to the dispersion of prices in a competitive market, and may need to distinguish more clearly not only between the prices faced by more and less engaged consumers, but also between consumers within the same company. Variation in prices offered by different suppliers poses different issues both from the consumer and market assessment perspective than does a similar variation within an individual supplier. In particular our response in part 2 emphasises the distinction between price discrimination (within the same provider) and price differentials. We have already seen in the energy market how limitations on price discrimination can result in poorer processes and outcomes. Limits on the differences between prices charged by different companies would involve considerable intervention on a similar scale to the price cap.

Question 3: What are your views on the structural changes that we propose to include in our framework? Are there any specific changes you think we should consider?

While smart metering does indeed provide new ways in which consumers *can* engage in the market (4.4, our emphasis), it raises similar questions about whether consumers will do so, and whether some groups who might be considered more vulnerable will be less engaged than others.

Third party intermediaries can clearly help in encouraging competition within the energy market, but commercial pressures in these markets may affect both their own functioning and that of the energy market itself, as illustrated by the debate over whether price comparison websites should be obliged to show the whole of market. The question may simply shift to how engaged and willing to search consumers are in the TPI market rather than directly in the energy market.

Question 4: Are there any indicators of the competitive process not listed here that you think we should consider in our analysis?

The discussion paper refers in various places to ensuring conditions for effective competition on the supply side (e.g. anti-competitive behaviour in figure 2). Ofgem will need to be aware of the potential for co-ordinated effects in this market, especially those which might arise from imposition of the price cap itself, any restrictions on relative prices and additional policies on the demand side.

Question 5: What are your views on the consumer outcomes that we propose to assess in determining whether the conditions are in place for effective competition?

Trust and confidence in the process are important features of transactional fairness, which is addressed in more detail in part 2 below.

Part 2: Transactional Unfairness and Price Discrimination

(Authors: Prof Bruce Lyons and Prof Robert Sugden)

Context of this response

This response addresses issues in Questions 1, 2, 4, 5 and 6. Our purpose is to sharpen focus on some importantly distinct issues that are not always clear in the Ofgem paper, or indeed in the wider political and regulatory debates on unfair pricing. In particular, we argue that regulators need a clear idea of what is an unfair consumer transaction, and this cannot be found in the standard economics of competition.⁵ We do not comment on whether this should be embraced within the concept of “effective competition” or whether it should stand separate. For current purposes, we note that Section 7 of the Tariff Cap Act (2018) requires Ofgem to conduct a review into whether conditions are in place for effective competition, and the Ofgem discussion paper includes issues we identify with transactional unfairness.

Formal definition of Transactional Fairness

Transactional fairness is about the relationship between a consumer and a firm. We take it as given that, for consumers to accept the legitimacy of the market, the intention of this relationship should be mutual benefit. Transactional fairness is not directly about rivalry between firms, though the firm should not hinder its customer from understanding alternative opportunities:

Transactional fairness requires that a firm intends mutual benefit with its customers, and acts in such a way that consumers with normal expectations are able to understand the consequences of transacting with that firm and are not hindered from understanding the consequences of transacting with an alternative seller.

Normal expectations should be understood to embrace the realities of behavioural consumers. Expectations are also likely to depend on, for example, the continuing nature of service and perceived oversight by a regulator. Transactional fairness embraces some issues usually categorised as consumer protection but it also embraces limits to price discrimination.

In applying our above definition, it is helpful to distinguish three contexts for transactional unfairness: pre-purchase for new customers; ongoing relationships with existing customers; and unfairness across categories of customer.

Unfairness Pre-Purchase

⁵ Bruce Lyons and Robert Sugden, ‘Transactional Unfairness and the Regulation of Consumer Price Discrimination’, (discussion paper in preparation). Foundations for our approach can be found in Sugden (2018), ‘The Community of Advantage: A Behavioural Economist’s Defence of the Market’, Oxford University Press. See also our consultation response (Part 1: Transactional Unfairness and Price Discrimination in Financial Services) to the Financial Conduct Authority’s consultation on ‘Fair Pricing in Financial Services’ (January, 2019), available at: http://competitionpolicy.ac.uk/documents/8158338/28916580/CCP+response_fair+pricing+financial+services.pdf/8503f377-783b-37c2-4527-2bc5be684f66

- It is unfair if a consumer is enticed by misleading information, or by hiding obviously relevant information, including by presenting information with misleading salience that draws attention away from what is likely to be most relevant.
- It is unfair if a firm hinders a consumer in comparing offers across alternative suppliers.

As an example of hiding obviously relevant information, suppose a firm has a range of tariffs subject to eligibility conditions. It is unfair for a firm to transact with a customer on tariff T1 when: (i) the firm also offers tariff T2, for which the customer is eligible; (ii) there is reason to believe that the customer would choose T2 if she knew it was offered; and (iii) the firm hides information about T2. We consider the possibility of unfair eligibility conditions below.

Unfairness in Ongoing Relationships

In the context of repeat transactions, a firm's fairness obligations are not executed and forgotten after the initial purchase.

- It is unfair if an existing customer does not receive updated relevant information on an appropriately regular basis and presented with appropriate salience.
- It is unfair if a firm hinders an existing customer in opting out or switching to an alternative supplier.

Unfairness Across Consumers

Although price discrimination per se is not necessarily unfair, unfairness can also be experienced in relative terms (i.e. compared with other consumers).

- It is unfair if a firm discriminates against individuals on the basis of their impaired capability to make sensible, well-informed decisions (i.e. they are unable to understand the consequences of the transaction). We call this transactional vulnerability.

For example, a wealthy person with impaired memory is *transactionally* vulnerable, whereas a person with low-income but good capabilities is not.

- It is unfair if a firm discriminates against individuals on the basis of criteria/eligibility conditions that are not part of a business model based on mutual benefit with its customers.

For example, suppose a firm has high fixed costs, then it may offer tariffs based on an indicator of willingness-to-pay, which would be consistent with pricing related to mutual benefit. A second example: new customers may be uncertain about the service level of an unknown new supplier, so be less willing-to-pay than are existing customers, and this can justify introductory tariffs. Price discrimination is not inherently unfair, but some eligibility criteria are (e.g. sex, race, religion, impaired capability to make sensible, well-informed decisions). We suggest the following test for tariff eligibility criteria:

Can the firm provide a reasonable explanation of its pricing practice, locating it as part of a business model based on mutual benefit, and would the firm be willing to give this explanation to its customers and expose it to public debate?

Note on Distributional Fairness

Transactional fairness should not be confused with distributional fairness. They are concepts with completely different roots. Also, crucially for policy implementation, corporate compliance with transactional fairness can be implemented unilaterally, while firms do not have the relevant information to implement distributional fairness.

While a degree of inequality is widely considered to be fair (e.g. inequalities due to differences in effort, risk taking or scarce talent), it is also generally considered that the current wealth distribution and access to resources would be improved by a reduction in inequality, particularly with respect to the poor.⁶ It is a standard economic argument that income and wealth inequalities are more appropriately addressed by tax and social security policies than they are by regulating prices. Just as tax and social security policies are naturally political decisions which should not be delegated to regulators, the appropriateness of a given level of inequality is an ethical judgment which does not sit comfortably in the hands of regulatory professionals.

Furthermore, it is not obvious that firms should be required to act to redress general inequality when governments have failed to act through the more appropriate policies available to them. Although this does not mean that distributional issues can or should be completely ignored when considering price discrimination, it does suggest a rather limited role (e.g. price discrimination should not result in low income households being required to pay a higher price than the wealthy for the same product). We note that even such a limited role may not be possible to implement because most firms cannot observe the wealth of their customers, at least without compliance with privacy law. Even with political guidance, corporate compliance with income-related pricing could therefore be impossible.

Some Implications of Transactional Unfairness for the Ofgem Discussion Paper

1. The Ofgem proposed definition of effective competition (#3.10) includes rigorous rivalry between firms and “good outcomes for most consumers in terms of what matters for them (e.g. price and quality of service)”. We suggest that it is not only these outcomes that matter to consumers, but the process behind how they are achieved. If a pricing practice is perceived as being *transactionally unfair* (e.g. in the language of Citizens Advice and the CMA, if there is a loyalty penalty), they will lose trust and confidence in the market.⁷ ***Alongside its competition analysis, Ofgem should facilitate compliance by setting out a code of conduct for domestic energy suppliers designed to implement transactional fairness.***

⁶ Some types of chronic illness and disability increase a person’s needs beyond those of the healthy (while not impairing their capability to make decisions). We include such additional needs in distributional fairness but refer to the “poor” for short.

⁷ “Trust and confidence” are recognised as being important in the last bullet of Figure 1 and #3.19.

2. “Prices and price differentials” [#3.19] and “dispersion of prices in a competitive market” [#3.21] are mentioned, but the implications of each are not articulated. ***Ofgem should be clear about how it interprets: the average level of consumer prices, differences in price levels across firms*** (which was controversially used by the CMA in its market investigation to imply lack of competition), ***price discrimination by a firm between its existing customer and new customers, and price discrimination within the firm*** (e.g. to discriminate against customers who are unlikely to switch). Each of these dimensions of price is differently related to competition and to transactional fairness. For example, as we say above in relation to transactional unfairness across customers, it is straightforward to justify price discounts (with new customer eligibility restrictions) to attract individuals who do not yet appreciate a firm’s quality of service. But it is quite different to hide relevant tariffs with existing customer eligibility or to create eligibility conditions that are not motivated by mutual benefit (e.g. some categories of price discrimination across existing customers).
3. The meaning of “vulnerable consumers” also needs clarification. #3.22 mentions “consumers in vulnerable situations, such as those with low incomes or disabilities”. The latter seems to relate to what we call distributional unfairness (low income or with greater needs, but who can make good decisions), which is quite distinct from what we call transactional vulnerability (unable to make good decisions). The empirical focus on switching suggests a third category, which may include those who do not care or who do not prioritise relatively minor savings (e.g. financially rich but time poor). Such individuals may or may not benefit from others who put effort into searching and switching. ***We suggest that careful consideration of our test question and discussion of transactional fairness across customers would help Ofgem in a more careful consideration of vulnerability and feed into the code of conduct we suggest above.***