

## **Ofgem's anticompetitive practice**

### **A response to Ofgem's consultation on the Undue Discrimination Prohibition standard licence condition**

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1. Ofgem has invited views on its 'minded to' proposal to retain the existing Undue Discrimination Prohibition standard licence condition (SLC 25A) until 31 July 2014.<sup>1</sup>
2. I argue in this brief response that Ofgem has not considered the available evidence on the effects of introducing this condition. This evidence suggests that the condition has adversely affected active residential customers without obviously improving the situation of inactive ones. The condition has also contributed to a reduction in 'churn' between suppliers and to a multiplicity of tariff offerings, both of which Ofgem has found problematic. This suggests that the condition has caused problems rather than solved them. It has restricted and prevented competition between suppliers, at the expense of customers. Continuing it without reviewing it as promised is inconsistent with due regulatory process. The condition should be allowed to lapse rather than be renewed.

#### **Background**

3. Ofgem explains that its Energy Supply Probe found "a range of differences in the prices of tariffs which could not be justified by cost. This included former electricity incumbents charging a higher price for their home regions ("in-area") compared to their entrant regions ("out-of-area")." (Consultation p 1) The Undue Discrimination Prohibition licence condition was intended to protect the less active in-area customers. It had a three-year sunset clause.
4. Ofgem reports favourably on the impact of the licence condition. "We found since the introduction of SLC 25A the average difference between a supplier's in-area standard tariff and out-of-area tariffs reduced from over £30 to around £13 in January 2011, per customer, per year. We therefore consider that the prohibition was successful in removing or successfully lessening the in and out of area price differentials." (Consultation p 2)

#### **The licence condition has not in fact protected customers**

5. But do more equal price differentials mean that in-area customers are better protected? Ofgem seems to have assumed that more equal differentials would automatically mean reduced prices to in-area customers. However, economists argued that, in the particular circumstances of these markets, it was more likely that suppliers would equalise differentials by increasing out-of area prices.<sup>2</sup>

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<sup>1</sup> Ofgem Consultation, Ref 23/11, 24 February 2012.

<sup>2</sup> E.g. Morton Hviid and Catherine Waddams Price, "Non-discrimination clauses in the retail energy sector", CCP Working Paper 10-18, University of East Anglia, November 2010, forthcoming in the *Economic Journal*, and literature reviewed therein.

6. Which turned out to be the case? Ofgem has claimed that the observed equalisation of differentials reflects a lowering of in-area prices.<sup>3</sup> However, “because of the volatility of the wholesale electricity market it is difficult to know what the counterfactual would have been”.<sup>4</sup>
7. There is another piece of relevant evidence. Ofgem has reported a steady increase in retail margins over the period since the introduction of the licence condition.<sup>5</sup> This suggests that the alternative interpretation is more plausible. That is, suppliers have raised prices to out-of-area customers rather than reduced them to in-area customers. Suppliers have gained by the enforced reduction in competition and customers have lost out.
8. In other words, the introduction of licence condition SLC 25A has made active customers worse off because they no longer have access to more attractive offers. But it has not made inactive customers better off. And there are serious questions whether vulnerable customers, in particular, are better or worse off as a result of the measures.<sup>6</sup> Thus, contrary to the claim in the Consultation paper, the licence condition has not in fact protected customers but in many respects has had the opposite effect.

### **Ofgem’s misunderstanding of the nature of competition**

9. Ofgem has been led to its incorrect conclusion for two reasons. First, it assumes that competition is measured by the extent to which price is equal to cost. On that basis, requiring an equal markup of price over cost would secure a more competitive outcome than would otherwise exist.
10. This reflects a misunderstanding of the nature of competition. In a market where some customers of incumbent suppliers are reluctant to switch it is to be expected that incumbent suppliers will seek to benefit from higher prices where they can. If some customers prefer to stay with their incumbent supplier despite a £30 price difference, competition will respect these preferences.
11. However, competition between these suppliers will mean them charging lower prices to invade other suppliers’ areas. Differential prices are a sign of competition, not a lack of it. A refusal to cut prices out-of-area, in order to maintain the same margins as in-area, would indicate a lack of competition. Unfortunately, a reduction in competition as a result of prohibiting price differentials is the situation that this licence condition has begun to bring about.
12. Second, Ofgem assumed (or gambled?) that prohibiting price differentials would have a beneficial impact on customers because suppliers would henceforth treat in-area customers as if they were out-of-area. In the event, this assumption/gamble has not paid off: suppliers seem to have found it more profitable to treat out-of-area customers as if they were in-area. Instead of making competition more effective for inactive customers, the licence condition has made competition less effective for active customers.

### **Other effects on competition**

13. The licence condition has also had another adverse effect on competition. By reducing the average available price differential by over a half, it has reduced

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<sup>3</sup> Ofgem, Update on probe monitoring, 1 July 2010, para 2.22 p 14.

<sup>4</sup> Hviid and Waddams Price, p 11.

<sup>5</sup> Ofgem, Electricity and Gas Supply Market Indicators, updated 4 April 2012.

<sup>6</sup> See Hviid and Waddams Price, section 4.

the potential benefits to customers from shopping around and changing supplier. This is reflected in the reduced ‘churn’ that Ofgem elsewhere notes with concern.<sup>7</sup> To be sure, other factors may have contributed to the reduction in churn, including Ofgem’s crackdown on selling techniques and the decisions of several suppliers to discontinue doorstep selling. But since the prospective gain from shopping around is an important determinant of churn, the licence condition will have been an important factor in discouraging customers from being active.

14. Suppliers have evidently sought alternative ways of competing by introducing other kinds of price reductions. Ofgem reports that “Since the Probe there has been a marked increase in the number of tariffs available ... Since 2008 the total number of available tariffs (online and offline) has increased by over 70%.”<sup>8</sup> But in the same report Ofgem expresses concern that the resulting multiplicity of tariffs makes it difficult for customers to decide whether it is worth switching supplier.
15. These two developments in the market – the reduction in churn and the multiplicity of tariffs - have led Ofgem to suggest an even more serious intervention in the market. It proposes to prohibit suppliers from offering more than one standard tariff per payment method, and to impose a uniform standing charge on all suppliers, to be set by Ofgem. Yet it now transpires that the two concerns that have contributed to this latest proposed intervention have been the unintended consequences of Ofgem’s own earlier misplaced intervention in the market.
16. More recently, the licence condition seems to present an obstacle to an interesting and potentially helpful development in the competitive market that could provide further protection for vulnerable customers. The organisation *Which?* has proposed the ‘Big Switch’, whereby it will negotiate terms with a supplier on behalf of all those customers who sign up. As of today, *Which?*’s website indicates that over 300,000 customers have expressed interest. Yet the major supplier SSE has declined to participate, including on the grounds that “It appears to risk breaking well-established Supply Licence conditions in relation to “cost reflective” and non-discrimination obligations”.<sup>9</sup>

### **Due regulatory process**

17. In introducing the Undue Discrimination Prohibition standard licence condition, and in monitoring the retail market subsequently, Ofgem said explicitly and repeatedly that: “We are also committed to a thorough review of the impact of the measures introduced as a result of the Probe, before SLC 25A terminates at the end of July 2012.”<sup>10</sup>
18. Ofgem now proposes to abandon this commitment. Instead, it proposes to review the extent to which SLC 25A is necessary “after any relevant RMR proposals have been properly implemented (assuming, following the

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<sup>7</sup> “We are concerned that the proportion of passive customers is growing. Since 2006, the proportion of consumers switching in any one year has been falling steadily. During 2010, 15 per cent of consumers report switching their gas supplier and 17 per cent report switching their electricity supplier. This compares to 19 and 22 per cent respectively in 2006.” Ofgem, *The Retail Market Review – Findings and initial proposals*, 21 March 2011, para 250, p 30.

<sup>8</sup> Ofgem, *The Retail Market Review – Findings and initial proposals*, pp 21-2.

<sup>9</sup> SSE, Letter to *Which?* 12 March 2012.

<sup>10</sup> Ofgem, *Update on probe monitoring*, 1 July 2010, para 4.4 p 23.

consultation process, Ofgem ultimately decided to implement relevant proposals)". (Consultation p 3)

19. Re-imposing the licence condition without the promised review is problematic for four reasons. First, breaking a regulatory commitment increases regulatory uncertainty, which in turn can be expected to increase the cost of capital and discourage new entry, both of which will lead to higher prices to customers. It will also reduce the credibility of a sunset clause in future.
20. Second, as explained above, the empirical evidence now available suggests that the outcome of SLC 25A has been the opposite of what Ofgem intended and expected. Arguments put to Ofgem at the time predicted that the licence condition would have these harmful effects.<sup>11</sup> These predictions have come true. It would be unreasonable not to take account of this. At the very least it would be unreasonable not to review the evidence systematically before re-imposing the licence condition.
21. Third, the responses to the RMR proposals have included some substantial objections. I have set out elsewhere my own serious concerns about the proposed new intervention in the market.<sup>12</sup> Many other responses to that consultation echo these concerns.<sup>13</sup> It must surely be questionable whether the RMR proposals will be implemented in anything like the form that Ofgem originally envisaged, and if so when.
22. Fourth, in the light of the evidence now available, Ofgem's sequencing is surely getting things back to front. To the extent that licence condition SLC 25A helped to cause the problems that led to the RMR proposals, the obvious remedy is not to implement these proposals then wait to see if SLC 25A is still necessary, but rather to abolish SLC 25A then wait to see if the RMR proposals are still necessary.
23. In the meantime, vulnerable customers *are* well protected by competition, despite Ofgem's protestations. The majority of customers that have not changed supplier say they are happy with their supplier, and competition does in fact protect them.<sup>14</sup>

## Conclusion

24. The Undue Discrimination Prohibition standard licence condition (SLC 25A) was intended to protect customers, but in practice it has had the opposite effect. It has reduced the value of the offers available to active customers without providing obvious benefit to inactive customers. It has contributed to higher retail margins for suppliers rather than lower prices to customers. It has made switching less attractive and thereby reduced 'churn' and the associated competitive pressure on suppliers. It has also encouraged suppliers to find other ways of competing, thereby increasing the multiplicity of offers that Ofgem claims to be problematic. And re-imposing it might now present an

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<sup>11</sup> As noted by George Yarrow, "Addressing undue discrimination: final proposals", response to Ofgem's final consultation, 13 May 2009.

<sup>12</sup> Stephen Littlechild, "Ofgem's Procrustean Bed", response to Ofgem's consultation, 23 January 2012. A shorter and slightly revised version is available at *Oxera Agenda*, February 2012.

<sup>13</sup> See also *Economic appraisal of Ofgem's domestic tariff proposals: an appropriate intervention to increase consumer engagement?*, Oxera, March 2012.

<sup>14</sup> For example, "Ofgem's charts suggest that competition generally forces suppliers to set their prices to sticky customers within 10 – 15% of the very lowest price in the market, a price that is sometimes alleged to be actually below cost." Ofgem's Procrustean Bed.

obstacle to the development of collective negotiation on behalf of vulnerable and other customers.

25. The licence condition has thus restricted and distorted competition. It has been anti-competitive rather than pro-competitive. And it has been against the interests of customers.
26. Ofgem rightly committed itself to a thorough review of SLC 25A and related measures before that condition terminated in July 2012. It has now abandoned that commitment. This is unhelpful regulatory practice.
27. In the absence of such a review, the available evidence indicates that SLC 25A has been harmful rather than helpful. For the sake of customers and competition, it should be allowed to fade away with the sunset, as originally intended.