

**Ofgem's Procrustean Bed:
a response to Ofgem's Consultation on its Retail Market Domestic Proposals**

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According to Greek legend, Procrustes, son of the god Poseidon, had an iron bed in which he invited passers-by to spend the night. They were told that it had the unique property that it would exactly match the length of whoever lay in it. In the event, if they were too short or too tall, Procrustes stretched or amputated them to fit.

In a surprising regulatory innovation, Ofgem proposes a similar treatment for all retail energy suppliers and their domestic customers. All suppliers will be limited to one standard tariff per payment method. Each year Ofgem will specify a common monthly standing charge for all the suppliers' standard tariffs. Those suppliers whose standing charge is too high will have to reduce it; those with a low or zero standing charge will have to increase it.

The passers-by did not survive. How will retail suppliers and domestic customers fare?

Ofgem's consumer research

What has led Ofgem to this remarkable proposal?

“Consumers have told us they would be far more likely to engage effectively in the market if it is easier to make comparisons between tariffs. In our quantitative research, 74 per cent of non-Economy 7 respondents and 76 per cent of Economy 7 respondents stated that they would be more likely to switch if a common standing charge and a price comparison metric were introduced.”¹

The quantitative research asked respondents to imagine that their electricity consumption was a specified number, chosen at random from 1000 to 5500 kWh per year.² Unfortunately, this means that a widowed pensioner on benefits could find herself asked to judge the cheapest tariff for a family of six with an electrically-heated swimming pool, and conversely. Respondents' own personal consumption and experience were thus rendered irrelevant.

Respondents were presented with four different sets of hypothetical tariff data labelled A to D. All sets had four suppliers. In sets A and B there were common standing charges; in sets C and D there were not. In sets B and D the data included a price comparison guide indicating the average monthly bill for low, medium and high users; in sets A and C this was not included. Respondents were asked which was the

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¹ Ofgem, *Retail Market Review – Domestic Proposals*, Ref 166/11, 1 December 2011, para 2.8 p 10. Subsequent quotations from this document unless otherwise noted.

² Ipsos Mori, *Consumer Reactions to varying tariff comparability*, Quantitative Research conducted for Ofgem, 18 October 2011.

cheapest supplier for their allocated consumption level, which method of comparing prices was easiest, which method they preferred, and whether provision of data according to this method would make them more likely to consider switching to a new tariff or new supplier.

Ofgem's summary is that 74% of non-Economy 7 respondents said they would be more likely to switch if the hypothetical data were presented with a common standing charge and with a price comparison metric (i.e. option B).

Views of other consumers

In fact, this is what the 39% of respondents that preferred option B said. But 61% of respondents did not prefer option B. They were not asked their views about the effect of introducing it.

We can nonetheless look at what these other consumers did say. (Ipsos Mori, Fig 3 p 12) 48% of respondents said they preferred one of the other three options for comparing the information (28% preferred A, 6% C and 14% D). If their preferred option for comparing information were made available, these other respondents respectively said they were 71%, 59% and 67% more likely to switch, with a weighted average of 68%. In other words, presenting the comparison as in option B, rather than as one of the other options, would increase the declared likelihood of switching not by 74% but on average by $74 - 68 = 6\%$.

It might be said that 77% of those who preferred option B thought that this would be an improvement. However, of those who preferred another option, an average of 74% thought their own preference would be an improvement. In other words, the proportion of respondents that thought their own option would be an improvement was only about 3% higher for option B than for other preferences.

Respondents were not told that price comparison information as in options B and D *is already available* on switching websites. (And available in hard copy for those who do not have easy access to the internet.) Focus then on those respondents who preferred the two options B and D that assume the availability of such price comparison metrics. The declared likelihoods of increased switching are 74% and 67% respectively. That is, with price comparison information available, those who prefer a common standing charge declare themselves only 7% more likely to switch than those who prefer different standing charges. There is no difference at all in the proportions (both 77%) that consider their option would be an improvement.

Turning to Economy 7, the claim that 76% of customers would be more likely to switch if a common standing charge and price comparison metric were introduced is even more tenuous. Consider again those customers that preferred a price comparison metric. A *lower* rather than higher proportion preferred common rather than different standing charges (25% for option B compared to 37% for option D). A slightly higher proportion declared themselves more likely to switch (76% with option B compared to 70% with option D, again a difference of only 6%). But a *lower* proportion of common standing charge supporters considered that their option would be an improvement (72% of option B supporters compared to 75% of option D supporters).

How convincing is this research?

The claim that three quarters of customers would be more likely to switch if there were a common standing charge and a price comparison metric is thus misleading. The availability of a price comparison metric is what is driving the respondents in the survey. Imposing a common standing charge makes little difference.

But how much weight should be attached to this research as a predictor of what customers would actually do, and hence as a guide to policy? What are we to make of a finding that about three quarters of respondents say they would be more likely to switch if a price information guide were made available - *when such guides are widely available and used in the market already?*

Or to take another example, should we place any weight on research that finds that only 6% of respondents would probably choose a variable tariff (Ipsos Mori Table p 26) – *when in reality about 75% of customers have actually chosen such a tariff?*

The reality is, that the quantitative research provides no basis for believing that consumers will be far more likely to engage effectively in the market if comparisons are made easier by requiring all suppliers to set a common standing charge.

Is there a problem that needs such intervention?

The Government has recently defended both the principle and practice of retail competition in the energy sector.

“This market structure has been effective. The liberal GB electricity market has delivered increased choice in tariffs and services and enabled consumers to switch suppliers. In addition, electricity suppliers are among the most reliable in Europe.”³

Why then is Ofgem concerned about the retail energy market?

“Our recent Consumer First Panel research also tells us that many consumers are disillusioned with the retail energy market and feel a sense of frustration in the face of rising prices. It will take a great deal to persuade many of these customers that engagement in the market is worthwhile. For these reasons we believe it is important to be bold in our reforms.” (p 1)

It is entirely understandable that many customers are aggrieved at rising prices. The average energy bill has doubled over the last ten years. But as Ofgem explains elsewhere, the causes are rising gas and oil prices; the cost of Government environmental and energy efficiency programmes; and the need to replace aging infrastructure, drive to a low carbon economy and connect to new supplies of gas.⁴

³ *Electricity Market Reform*, DECC Consultation Document, Cm 7983, Dec 2010, para 9 p 20.

⁴ Ofgem, *Why are energy prices rising?* Factsheet 108, 14 October 2011.

In terms of prices, the UK has not fared worse than other countries: Ofgem's figures show that UK electricity and gas prices compare very well against other European countries. Electricity prices have also followed fuel costs.⁵

There have been allegations that UK retail energy prices are quick to follow upwards movements in wholesale prices but slow to follow them down. Some energy companies have disputed this. But whether or not it is true in the UK energy sector, there is evidence that output prices respond faster to input price increases than to decreases in more than two thirds of a wide variety of other markets.⁶ The reason for this is as yet not understood, but it seems to have nothing to do with market power.

Customer complaints seem no worse than in other sectors like telecoms, rail and banking. They may well be correlated with price increases.

The UK retail energy market consistently scores highly in international comparisons of competitive vitality. Ofgem is concerned that the rate of 'churn' – the percentage of customers that switch supplier per year - has fallen from just above 20% in 2007 to just below 20% now. But 2007 was a peak level: churn in the UK has more generally been in the 15% to 20% range. It is typically higher in the UK than in most other competitive retail energy markets including Norway, Sweden, Texas and New Zealand.

There has been new entry into the retail sector. Centrica entered the electricity sector from the gas sector, and the major electricity suppliers expanded into the gas sector. Numerous small-scale entrants have provided a particularly valuable protection for customers, offering lower prices and/or innovative services. But the total domestic market share of the smaller suppliers has hovered at around 1%. This does not suggest that there are massive excess profits to be competed away.

Ofgem has made its own calculations of retail profits. These figures have been challenged, but they are presumably the basis for Ofgem's policy at present. They are consistent with the point just made. Ofgem's calculated average net profit margin of the retail suppliers has been very low. On dual fuel products the calculated net margin was actually negative over almost the entire five year period from August 2004 to August 2009.⁷

Sticky customers

Ofgem is now concerned about 'sticky' customers.⁸ It says that offline prices to customers who do not switch are not as good as the terms offered to those customers who actively seek out the best online deals via the internet.

⁵ "The market has performed well over the period since privatisation and liberalisation. The UK market has ... resulted in electricity prices which have been comparatively low and fairly responsive to movements in fuel costs." *Electricity Market Reform*, para 13 p 22. It adds "DECC analysis shows UK day-ahead wholesale electricity prices have generally followed day-ahead NBP gas prices."

⁶ Sam Peltzman, "Prices rise faster than they fall", *Journal of Political Economy*, 108(3), June 2000.

⁷ Ofgem, *The Retail Market Review – Findings and initial proposals*, March 2011, Fig 2.13 p 43.

⁸ "Sticky consumers are those customers that choose not to switch, cannot switch due to their circumstances, or are put off switching due to other features of the market such as tariff complexity. In the March consultation we estimated that around 40-60 per cent of customers in the energy sector are

But this is how competitive markets normally work. Suppliers have to offer better deals to active customers with more elastic demand, otherwise they lose them.

At the same time suppliers search for ways to improve the value of the service they provide to customers with less elastic demands. Their aim, no doubt, is to charge more for this higher value. But does this mean that sticky customers lose out in competitive markets? No, because the more that suppliers raise their prices, the more attractive these customers become to competitors. Even sticky customers can be tempted to switch. So suppliers cannot let their prices to sticky customers get too far out of line with the prices that obtain for active switchers. All customers thereby benefit from retail competition.

The empirical evidence bears this out. Ofgem's various charts suggest that the best online price on offer in the market at any time ranges from about 2% to about 20% below the average offline price.⁹ Typically, the gap seems to be of the order of 10 to 15%. This is a quite remarkable achievement. Retail competition seems to be ensuring that even sticky customers who make no attempt to change supplier are receiving a price that is within 10 to 15% of the very best price in the market – a price that is sometimes alleged to be actually below cost.

In this respect the UK energy sector seems to stand comparison with even the most competitive markets for other goods and services. A casual browsing of the internet suggests the frequent availability of price offers in other markets (including other energy markets) that are more than 20% below what other customers (presumably the sticky ones) are paying. Sticky customers are in fact well protected in the UK energy market. It simply is not necessary for most customers to keep switching in order to get the benefits of retail competition.

Will all customers benefit from Ofgem's latest proposal?

Ofgem asserts that “almost all consumers will benefit” from its proposal because tariffs will be more comparable and easier to understand. “Disengaged” consumers are likely to benefit from the consolidation of standard tariffs because they are likely to be on suppliers' higher price standard tariffs, and because they would benefit from the ‘ripple effect’ of switching by active consumers.

But surely, by the same token, active and engaged customers that have sought out lower price tariffs will suffer from this consolidation of tariffs? And if active customers' ability to benefit from switching is reduced, will this not reduce their incentive to engage, and in turn reduce the ripple effect?

Previous experience

Previous experience does not provide confidence that Ofgem's manipulation of the retail market will benefit customers. Until 2009 suppliers were cutting prices to compete outside of their local areas. Ofgem objected to them not cutting prices

currently sticky (although we recognise they may have switched in the past) and that vulnerable customers are likely to be disproportionately represented in this group.” (fn 6 p 8)

⁹ E.g. Ofgem, *The Retail Market Review – Findings and initial proposals*, March 2011, Fig 2.8 p 35.

within-area too. It therefore introduced a non-discrimination requirement (Condition 25A). Economists warned that enforcing equal prices would lead to the removal of the lower prices rather than the higher ones. There would be a reduction in competition and higher profit margins.

Ofgem's calculations show that the net profit margin has indeed increased since 2009. This suggests that the warnings were valid. Fortunately, Condition 25A expires in June 2012 – except that some companies, understandably from their shareholders' perspective, are now suggesting it be continued.

Experience in the financial sector

Ofgem explains that its policy in the retail market is informed by insights from behavioural economics.¹⁰ On the basis that a common standing charge and a price comparison metric would significantly improve consumer decision-making, “we need to nudge consumers to engage with this information to compare tariffs” (para 2.8). Ofgem's review of “behavioural economics in practice” gives two examples of such attempts to influence consumer decision-making actually carried out by another UK regulator.

The Financial Services Authority (FSA) commissioned studies to examine the impact of extra information upon consumers' decisions to purchase insurance,¹¹ and the impact of providing extra and standardised information to consumers on their decisions to purchase mortgages¹².

5.16. The [first study] found that providing extra information about the product's value for money (claims ratio) and the sellers' incentives (commission) had no real impact upon purchasing decisions. Consumers recognised this information was important but were unable to use it in a consistent manner to change their behaviour. However, this extra information did make consumers feel less confident about the decisions that they made. This means that the overall impact of more information on consumer wellbeing was ambiguous. While consumers valued having the information, or recognised its importance, it did not enable them to change their decisions and they became less happy about their actions.

5.17. The quantitative analysis examined whether the Key Facts Information (KFI) that was introduced through Mortgage Conduct of Business (MCOB) regulation improved consumers' decisions about purchasing mortgages. MCOB was introduced in 2004 to improve the ability of consumers ‘to make informed choices in the mortgage market and so to buy lower cost and/or more suitable products for their needs’. The KFI was intended to standardise and simplify information about mortgages. ... [The second study] found that after MCOB there were better mortgages available in the market. However, mortgage prices increased after MCOB. They concluded that this could have reflected costs of MCOB being passed through by lenders. They also found that after MCOB, consumers bought mortgages that offered poorer value for money to them.

¹⁰ Ofgem, *What can behavioural economics say about GB energy consumers?* Appendix 1 Behavioural Economics in Practice, 21 March 2011, pp 21-2.

¹¹ Meza, D., Irelenbusch, B., Reyniers, D. 2007, “Information versus persuasion Experimental Evidence on Salesmanship, Mandatory Disclosure and the Purchase of Income and Loan Payment Protection Insurance”, Available from: http://www.fsa.gov.uk/pubs/other/DeMeza_Report.pdf

¹² Monteiro, N and Ziadi, R 2007, “Market impact of MCOB”, Available from: <http://www.fsa.gov.uk/pubs/occpapers/op27.pdf>

5.18. These findings indicate that consumers value having greater access to information they think is important. However, they have limited capacity to process extra information when making their purchase decisions. The second study also highlighted that providing this information can be costly. Further, it is possible that extra information can harm consumers' feelings of wellbeing.

These outcomes should give pause for thought.

Four important tariff innovations

Retail competition in the energy sector has encouraged suppliers to discover and provide a variety of new tariffs that are better geared to meet the differing needs of particular groups of customers than a single regulated tariff is able to offer.

The most important tariff innovations in the UK retail energy market have been the following:

- the availability of tariffs with no standing charge: something that a great many smaller and lower income customers had been insistently requesting throughout my nearly ten year period of office. To be sure, the unit price on such tariffs would need to be somewhat higher in order to cover the costs of serving such customers, but these customers accepted that. What they wanted was a tariff where the amount of their bill was directly subject to their own control;
- the availability of discounts for online purchase and for dual fuel: to recognise the cost savings and other commercial advantages provided by such customers, and to reward these customers for their additional effort, cooperation and loyalty. Competition enabled the levels of these discounts to be set in the market without a regulator having to dig into the costs and pronounce on what these benefits were worth;
- the availability of tariffs for green electricity, to enable those customers who wished to do so to make a contribution to the environment, where they could choose the nature and extent and cost of this contribution. Again, competition meant that the regulator was not called upon to dictate how green should be defined and at what additional price it should be made available.

Not surprisingly, the Ipsos Mori study found that customers, too, value these options.

“... additional features such as internet access, dual fuel and green tariffs are popular among consumers. When asked about their preferences for additional features, a majority would choose internet access and dual fuel features themselves”. ... “Just 10% of consumers, vulnerable or not, would select green tariffs for themselves, though a further 47% of all consumers and 44% of vulnerable consumers would like to see them made generally available.” (Ipsos Mori, pp 33, 27)

What is to become of these options under Ofgem's proposals? Standard tariffs with these features are to be prohibited. At one stroke, the four most important and valued tariff innovations that retail competition has brought to the UK are to be abolished. How can this be consistent with promoting competition and the interests of customers?

Ofgem is evidently uncomfortable on this point. It says that “the removal of dual fuel ‘discounts’ from standard tariffs carries a risk of frustrating a significant number of consumers and possibly hampering our attempts to promote engagement”. (para 2.59) It would surely be more honest to admit that it *will frustrate* a significant number of consumers and *will hamper* attempts to promote engagement. Ofgem continues, “Given that consumers exhibit status quo bias, great care will be needed in communicating the benefits of our proposals”. That is one way of putting it.

Consequences for suppliers

Ofgem acknowledges that its proposal might (more accurately, *would*) adversely affect the risks and costs of suppliers, and do so differentially.

2.60. The single regional standing charge may increase the risk faced by suppliers and could affect smaller suppliers more than larger suppliers. If an element of cost used to set the standing charge were to rise during the period for which the standing charge were fixed, it would be necessary for suppliers to finance the shortfall either from their cash / capital reserves or by raising the unit price of standard tariffs. As small suppliers tend to have smaller cash / capital reserves than large suppliers (as a proportion of revenue), they may have less scope to absorb cost changes.

2.61. We also recognise that the “no adverse unilateral variation” restriction on suppliers’ non-standard tariffs could significantly affect the ability of suppliers to pass through changes in network costs during the fixed term. This additional risk is likely to affect smaller suppliers more than larger.

2.62 ... the price comparison guide is less suitable for innovative Time of Use tariffs. ... This increases the risk that a price comparison guide could mislead consumers about the savings they could make.

2.63 ... The one-off cost associated with creating new tariffs and migrating a proportion of customers to the standard options may be large and is likely to vary between suppliers. Further, all suppliers would be required to publish tariff information in a specified format and so would incur ongoing costs.

In a competitive market, these additional costs and risks will of course be passed through to customers. Any inability to pass on additional costs incurred, and uncertainty as to when and how far the regulator would approve an increase in standing charge, would increase regulatory risk. To offset this risk, suppliers could be expected to set higher unit charges than they otherwise would, or defer reductions in those charges. The regulatory restrictions would also reduce the ability and incentive for suppliers to innovate.

Implications for Ofgem

Ofgem acknowledges that it, too, would incur additional costs as a result of the substantial additional regulatory burden involved.

2.64. Ofgem would also incur costs under the RMR core proposal. We would regularly review and amend the level at which standing charges are set in light of changes in relevant costs. We would also monitor the impact of the proposals on consumers, especially vulnerable groups, and would monitor how suppliers implemented the revised tariff structures and information remedies. We would investigate any possible breaches and would take enforcement action against any suppliers found to have breached the licence conditions.

These additional costs would of course be charged to suppliers and hence to customers. But increased costs of regulation would not be the only consequence for Ofgem.

With Ofgem now determining which standard tariffs are allowed and which are not, and setting a common standing charge for all of them, a significant component of the retail energy market price becomes the direct responsibility of the regulator. Ofgem's actions would have immediate implications for different types of customer and different suppliers. This can be expected to increase the extent of lobbying, with requests to reduce or increase standing charges, and to allow or disallow exceptions or modifications. Regulatory costs and risks would increase accordingly.

The type of tariffs allowed and the standing charges thereon would become an important media issue. Once a year, attention would focus on what change in tariffs and charges Ofgem is to mandate. Whereas tariff decisions are now thankfully dispersed, with different companies taking decisions on different tariffs at different times, under this regulation all companies and most customers would be affected by one regulatory decision on one day per year.

Not only Ofgem and the media would be involved. It is inconceivable that, on a matter of such significance, the regulator would not discuss its thinking in advance with the minister of energy, and take note of any comments that the minister wished to make. Each party will of course respect the independence and statutory responsibilities of the other. But it would be surprising if certain questions were not discussed: whether this was the right time for a price increase, or an increase of this magnitude, or whether a decrease might now be considered, or whether it might not now be prudent to allow pensioners to have access to a standard tariff with no standing charge, and so on.

A reminder of the past

Before proceeding down this road, let us remind ourselves what electricity pricing used to be like under government ownership, and why privatisation and competition were deemed so necessary to remedy the situation. Until the late 1980s, energy prices were increased, decreased or left alone according to what was politically convenient at the time. There were guidelines, of course, like "breaking even taking one year with the next", but these were interpreted flexibly.

The consequences included an ambiguity about economic and financial responsibility throughout the sector, prices that reflected political convenience rather than costs, both at the aggregate level and by individual tariff, a systematic suppression of vital information about the costs of different technologies, and a consequent series of poorly informed investment decisions that significantly increased the costs to customers over the longer term.

Facing reality

Retail energy prices have doubled in the last decade. Ofgem perceives, no doubt rightly, that many customers understandably feel disillusioned and frustrated. But

rather than shoot the messenger, let us be grateful that such a clear delivery of the message enables and prompts us to understand what is causing this. We can thereby consider what action is best fitted to ameliorating the price increases, and how best suppliers and customers can adapt to the situation.

Ofgem has set out the underlying causal factors: primarily the increases in world fuel prices and the cost of meeting UK policy on the environment and security of supply. These factors have increased costs throughout the whole energy chain: at wholesale, transmission, distribution and retail levels. No convincing evidence has been presented that the retail market is less competitive than other markets generally, or that it provides less protection for sticky customers.

A competitive retail market will incentivise suppliers to keep down wholesale and retail costs where they can, and to offer to customers the best deals they can provide. But even the most active retail market imaginable – hypothetically, for example, one in which all customers received the best price in the market rather than the average retail price - would have made not a jot of difference to the impact of the two main causal factors identified, or to the broad pattern of wholesale and retail prices over the last decade, or to the present extent of consumer disillusion and frustration.

77% of consumers who have not switched supplier say they are happy with their current supplier.¹³ In another survey, 92% of them agreed that “Once I find a product or service that I think is OK, I tend to stick with it.”¹⁴ There is no reason to believe that restricting each supplier to one standard tariff, having Ofgem dictate a common standing charge each year, and imposing a raft of other restrictions on suppliers, will encourage more customers to engage actively in the market. The interpretation of the consumer research adduced to support this policy does not stand up to scrutiny.

There is more reason to believe that the proposed policy would have the opposite effect. It would prevent suppliers from offering what customers want. In particular, it would deprive customers of the options to choose standard tariffs with zero standing charges, online discounts and dual fuel discounts, and green tariffs. At a stroke the four most distinctive and customer-valued tariff innovations since the introduction of retail competition would be banned. The policy would impose additional costs and risks on suppliers and on Ofgem that would translate into additional costs for customers. It would put Ofgem in the position of allocating costs and benefits between suppliers and customer groups. Energy prices would once again become a political matter rather than an economic one.

Reformulating the problem

Is it really sensible radically to amputate the retail market, in a policy that manages to combine Greek mythology, Luddism and postwar Soviet control? Can we not find a policy more suited to the thinking and conditions of the 21st century?

Future wholesale market conditions are unknown and may well be adverse: there will be unpredictable fluctuations in fuel costs and in general all the components of the

¹³ Ipsos Mori, *Customer Engagement with the Energy Market – Tracking Survey*, January 2011.

¹⁴ Centre for Competition Policy (University of East Anglia), Response 34 to Ofgem’s RMR consultation, June 2011.

energy price chain seem likely to continue to increase for the foreseeable future. Technological change is inevitable but unpredictable. Ofgem elsewhere draws attention to the rollout of smart meters and the increased opportunities for demand side participation. Innovation, complexity and choice will increase, not decrease.

In these difficult and unfamiliar circumstances, an unresolved question is what kinds of retail products will give customers the protection and reassurance that they most value over a period when they may well feel disillusioned and frustrated, especially if the regulator keeps telling them that they are being exploited.

Specifically, in times when energy prices are uncertain and may increase, do customers prefer prices that are varied as and when the supplier feels it needs to do so? Or at regular monthly or quarterly intervals, related perhaps to spot price or to some index of cost? Or do customers prefer prices that are fixed for one, two or three years at a time? What proportion of their bill do they prefer to be fixed via a standing charge and what proportion related to usage? Do they want to monitor prices regularly and engage actively in the market, or would they prefer to stick with their existing supplier and not be bothered, or do they want to explore the market just occasionally when they see some reason to do so?

Experience to date has shown that different customers have different priorities. Some prefer a fixed price but more do not. Some wish to be active but the majority do not – at least, not all the time. Fixed-price fixed-period deals have not proved as attractive as some expected, while in Scandinavia spot price deals have been more popular than expected. In the UK, where there has not been a widely accepted spot price, such deals have not emerged.

Shall we find better answers and better solutions by having a regulatory body limit each supplier to one standard tariff, dictate a common standing charge for all suppliers that it will change once a year, and prescribe in detail the terms and conditions that each supplier shall offer? Or are we more likely to find ways ahead by encouraging more variation, with rival suppliers able to offer whatever terms they think customers might like better than what their existing supplier offers?

No doubt many customers are confused by the number and variety of energy tariffs. This is indeed a real challenge. Most of us are confused by the number and variety of prices and specifications for products and services with which we are not familiar, whether these be supermarket products, laptops, mortgages or whatever. Observers have found errors and failures to choose the best energy deal. But this is increasingly recognised to be true of consumer behaviour generally, in all markets.¹⁵ That is why many customers are guided by habit, experience or reputation, rather than by a regular and detailed numerical comparison of all the offers available at any time. Sticky customers are not an aberration of the UK retail energy market: they are and always have been an intrinsic feature of all markets everywhere.

How best to cope with this mountain of confusing information? Is it better to prohibit variation and to specify a regulatory straightjacket, allowing only the information that

¹⁵ E.g. Ofgem, *What can behavioural economics say about GB energy consumers?* 21 March 2011. Daniel Kahneman, *Thinking, Fast and Slow*, Allen Lane, 2011.

the regulator deems appropriate for making comparisons, and desperately hoping that customers will change the habits of a lifetime? Or shall we build on the numerous comparison websites and advisory agencies that already exist, in effect competing with each other to discover and provide the means of comparison and choice that customers themselves deem most understandable and relevant? Is there not more scope for Ofgem to work with suppliers and such agencies to achieve greater transparency and customer satisfaction without restricting innovation and differentiation?

Reference to the Competition Commission?

Ofgem has consistently said that, “if it becomes likely that suppliers will oppose our proposals, we retain the option that we have flagged in our previous consultations of referral to the Competition Commission for a market investigation reference”.

Suppliers’ responses to the March consultation certainly indicated some serious reservations about many aspects of Ofgem’s proposals. Is a Competition Commission reference now appropriate?

A utility regulator is in a difficult position when prices increase. Its principal objective is to protect the interests of consumers, present and future, wherever appropriate by promoting effective competition. But it is never easy to say, “There is not really a problem, there is no need for the regulator to take action”. The regulator has to be seen to be standing up for the interests of customers on day-to-day basis. Some would interpret that as requiring tough action against the companies, whatever the cause of the price increases. A regulator may feel the need to be seen to “do something”.

When there is a clear case against a regulated company, and an obvious remedy that the company refuses to accept, a reference to the Competition Commission is the normal procedure. It is less appealing for a utility regulator to make a reference saying, “Some think there’s a problem, here, some don’t, see what you think”.

Nonetheless, a reference to the Competition Commission may now be appropriate. To my mind, Ofgem’s proposals are so extreme, and so inconsistent with the interests of customers and the promotion of competition, and the case for them is so implausible, that it would be preferable that another body should take a more considered look at the situation. However, another policy option may be worth considering first.

An alternative proposal for policy

In the Greek legend, Procrustes’ reign of terror was ended by Theseus, who turned the tables on him, fatally adjusting him to fit his own bed. Only partly inspired by Theseus, here is a suggestion for addressing Ofgem’s concerns that particular customers may be disadvantaged at present.

Let the six major energy suppliers each put up £1 - £2m to establish a new energy supplier, whose directors are to be nominated by Ofgem and the various consumer representative groups such as Consumer Focus, Citizens Advice and Age UK. The new supplier will adopt whatever purchasing policy, price offerings, terms and conditions and sales promotion strategies that these organisations consider will best

protect the interests of customers, particularly vulnerable ones. Or – a less expensive option – let the new supplier act on a ‘white label’ basis, repackaging or recommending the offerings of other existing suppliers. The sole restriction on the new supplier’s activities, other than the normal retail licence conditions, is that it should earn a reasonable return on the initial capital and not run at a loss.

With this regulatory-approved option now available to all customers, Ofgem can drop its proposed restrictions on retail services and suppliers. Customers can be reassured that the new supplier will offer them the best terms that the market can provide, and will not exploit them. The new supplier’s terms will become a benchmark against which the terms of other suppliers may be compared. They may even be taken as an indication of when price increases or reductions are justified.

The experience of this supplier will also provide customers, their representative organisations, and not least Ofgem itself, with a better understanding of the challenges facing all retail suppliers. How best to forecast and hedge against movements in fuel prices and shifts in demand? How to assess the extent and timing of price changes? How to discover what kinds of tariffs different customers prefer? How to design offers that will appeal to customers and to communicate the merits of those offers? How to deal with customer enquiries and complaints? How to work throughout within the regulatory constraints? In this way, vulnerable customers are directly protected and better understanding of the retail market is available to all.

Meanwhile, Ofgem has other more important tasks. It is rightly considering the possibility of reforms to the cashout mechanism that could provide a spot price, increase liquidity and facilitate the entry of new and smaller players into the market. It also needs to consider how best to protect the interests of consumers and promote effective competition in the context of the Government’s evolving energy policy, not least in setting network price controls. These areas, rather than demolition of the retail market, are where Ofgem’s time and expertise are most required for the foreseeable future. And domestic customers would sleep more safely in their beds.