

Competition and the UK retail energy market: Lessons for Australia?

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Outline

- Competition and Ofgem regulation 1998-2014
- CMA investigation and remedies 2014-2016
- Political developments 2017
- Understanding Ofgem's policies & possible remedies
- Critique of CMA analysis & need for more challenge
- Behavioral economics and competition economics
- Evidence on latest market developments & regulatory trials 2017
- Lessons for Australia?

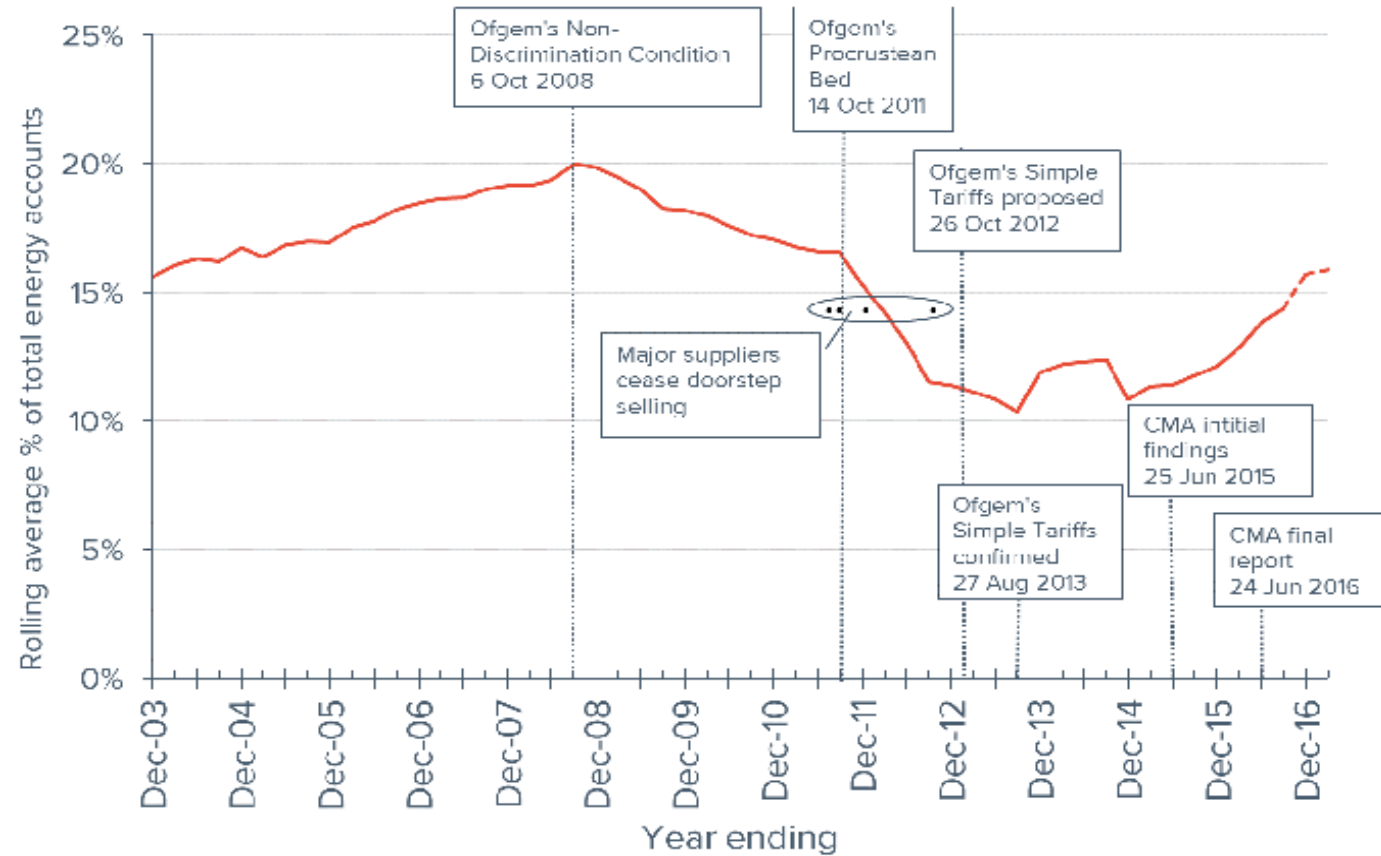
Market opening 1998 to Ofgem's Probe 2008

- c 1998 UK domestic retail energy markets opened
- 1998-08 Vigorous price competition, innovation, customer switching
- Jan 2008 “Market is sound, Ofgem assures Chancellor”
- Feb 2008 Ofgem Probe “to address mounting concern among customers”
- Found high levels of switching but few customers confidently engaged
 - Less active customers paying £1bn per year more than active ones
- Proposed 20 measures to promote more customer engagement

Non-discrimination condition 2009-2012

- Probe also found “unfair price differentials”
 - incumbent suppliers charged higher prices to customers inside former monopoly areas & lower prices to customers outside
- Non-discrimination condition: prices should reflect cost differentials
- Result: lower price differentials but also higher prices & profits
- Suppliers introduced other forms of tariff to compete
 - Eg fixed v variable tariffs, introductory discounts, prompt payment discounts
- Also crackdown on door-to-door selling, suppliers abandoned it
- Customer switching (churn) halved

Customer energy switching rate 2003-2017



Ofgem's Retail Market Review (RMR) 2011

- Ofgem attributed fall in switching to “complex pricing structures” and “increase in number of tariffs available”
- “Further radical actions required to make it easier to compare prices”
- 2012 Simple Tariffs (max 4/supplier, most discounts banned)
- StayWarm tariff (fixed monthly bill to over 60s) did not comply
- Innovation restricted e.g. wholesale tracker tariffs not developed
- Suppliers withdrew Minority tariffs (eg Green) to focus on popular ones
- But these measures did not alleviate popular concern, no recovery in switching, and question whether measures were sensible anyway?

Competition & Markets Authority (CMA)

Investigation 2014-2016

- 2014 Ofgem referred sector to CMA, noted 5 issues of concern
 - Excluded large customer market: “little evidence of harmful features”
- CMA found no problem with 4 of 5 main issues
 - incumbency advantage, tacit coordination, vertical integration, barriers to entry
- Ofgem’s Simple Tariffs policy had an Adverse Effect on Competition (AEC)
 - Restricted price competition, desirable tariffs, innovation, & no obvious benefit
- Remedy: Remove Simple Tariff restrictions (now done)
 - New Tariff Comparability clause – help customers make informed choices
- CMA found less effective competition for PrePayment Meter (PPM) customers (4m, 16% total) - Remedy price cap on PPM tariffs (done)

Weak customer response & detriments

- CMA found customers not responding to large price differentials
 - Max saving ave £164/year 2012-15, £330 in Q2 2015
 - (on ave dual-fuel bill c £1000/year)
 - Low income, less educated, renting, older customers less engaged
- “Weak customer response” gave suppliers market power, which they exploited via level of prices & price discrimination
- Customer detriment average £1.4bn pa, £2bn in 2015
- Remedy for weak customer response: greater customer engagement
 - E.g Disengaged Customer Database: details made available to other suppliers

More extensive price controls?

- CMA Conclusion: extensive price controls would undermine competitive process, with potentially worse outcomes for customers in long run, by reducing customer incentives to engage, reducing supplier incentives to compete, and increasing regulatory risk
- CMA Dissenting View (Prof Martin Cave): present harm very severe (£2b/yr = £75/household), remedies will take time & untried & untested, other information remedies 'had not made a dent' in number of customers on Standard Variable Tariffs (SVTs)
- He proposed to extend PPM price cap to SVT customers (about 70% of total) for 2 years

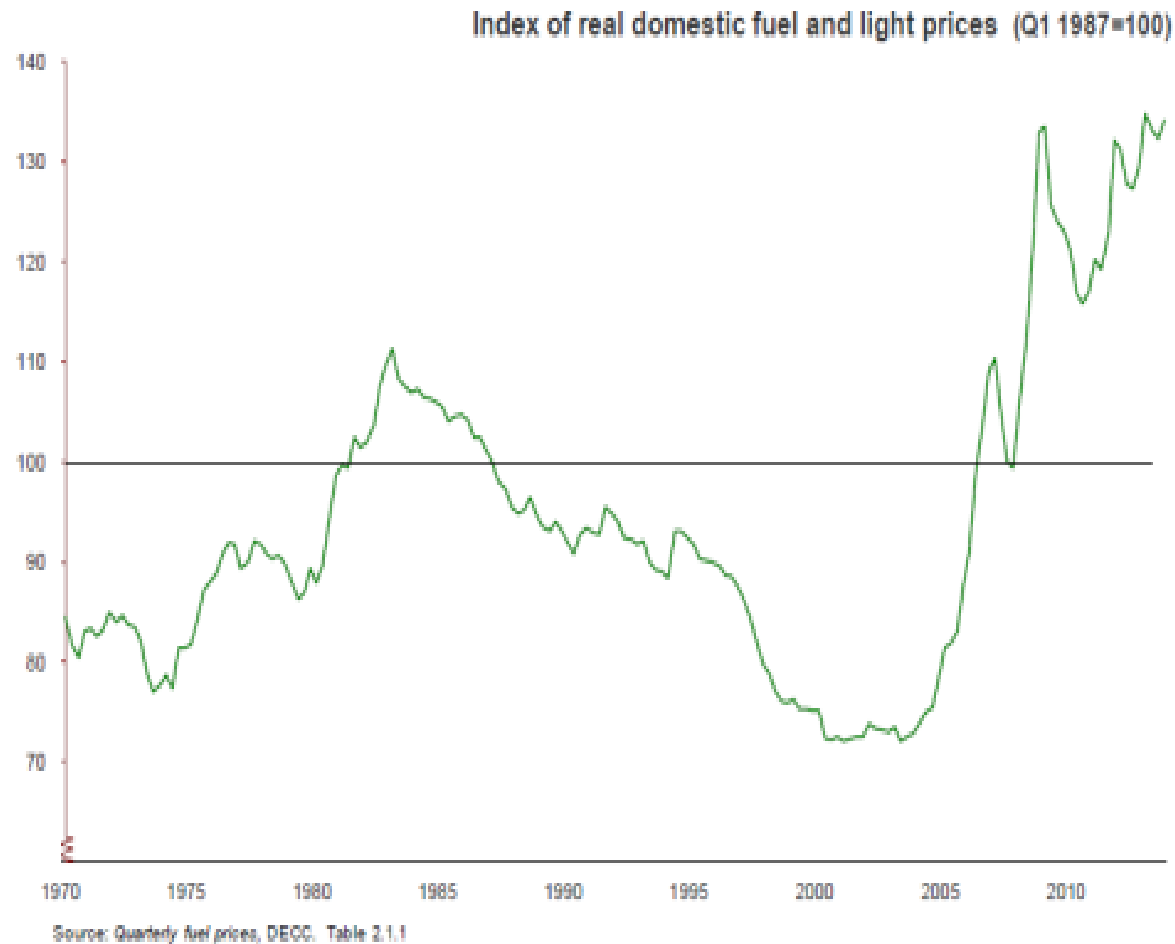
Political developments 2017

- Feb: March large suppliers announce price increases
- April: PM declares election, intends to deal with 'rip-off energy tariffs'
 - Most election manifestos proposed price controls & other measures
- June: Sec of State asks Ofgem what it intends to do
- Ofgem: extend PPM price cap to another 1m vulnerable customers by Feb 2018 (+2m more later), but suppliers would contest imposing cap on SVTs
- Sept: Sec of State gives Ofgem 'final warning' to eliminate £1.4bn customer detriment. Ofgem declines to do so.
- Oct: draft Bill to order Ofgem to impose price control.
 - Nov: Sel Committee begins pre-legislative scrutiny 'to fix broken energy mkt'

Understanding Ofgem's policy & remedies

- Why did Ofgem reverse its policy in 2008?
- Energy prices roughly doubled (see next slide) – Ofgem under pressure
 - Energywatch: “Ofgem complacent at best, negligent at worst”
- Ofgem Probe noted increases in world fuel prices, but discussion technical
- Left suspicion of excess retail profits – but not justified by data
 - Data showed average retail profit margin 2005-2007 was negative
- CMA concluded “Ofgem's inability to address concerns about profitability ... led to Ofgem interventions that had adverse effect on competition”
- CMA remedy: Better reporting on retail profits (including balance sheets)

Context: energy prices suddenly doubled



Price differentials in UK

- Ofgem 2008: price differentials without cost justification are “unfair”
 - Shows competition not working – must “accelerate transition to competition”
- But economic literature shows differentials can indicate competition
 - Competition can force firms to discriminate (Baumol)
- True in retail energy sector: prices to more active customers forced down to marginal (energy) cost, less active SVT customers cover overheads
- But at margin all customers can & do switch, both sets of prices reflect costs & are competitive, overall profits in UK not excessive (see below)
- CMA suggestion: create Office of Chief Economist at Ofgem
- Suggest: need to reduce pressure on Ofgem to intervene - transfer responsibility for now-competitive retail market to competition authority

CMA calculation of customer detriment

- Customer detriment average £1.4bn per year (2012-15): “direct approach”
- CMA aimed to compare prices: Big6 v 2 mid-tier suppliers
- But CMA had to make substantial adjustments to ensure comparability
 - Energy supplier at efficient scale, in steady state, earning normal return
- Detriment is comparison with hypothetical efficient state, not excess profit
- Much disputed
 - OXERA advising SP: Correct detriment in range minus £720m to plus £755m
- And not transparent
 - CMA made 2 final adjustments not made previously, total c. £1bn, after closure of data rooms - no-one could see & comment on details of calculation

CMA “indirect approach” to customer detriment

- Excess profits (ave £303m) + inefficient costs (ave £420m) = £723m
- But no excess profit by standards CMA applied to large customer market
 - Applying CMA’s risk-adjusted I&C EBIT margin benchmark in domestic market would remove £300m
 - Large customer market so competitive didn’t need investigation
- Profits specific to 2 most efficient suppliers
 - BG had 2/3 total sector retail profits, BG+SSE 95%, these suppliers had lowest costs
 - 2 other Big6 suppliers had ave profits around CMA competitive level, 2 had losses
- This does not support claimed sector-wide “weak customer response”
- Inefficient costs = actual less lower quartile costs
 - “large part of detriment [over 50%] likely due to inefficiency rather than excess profits”
- But cost differentials in all real competitive sectors – why is this a customer detriment?
 - Not a conventional competition authority approach
- No adjustment for losses born by shareholders not customers

How to improve CMA analysis?

- CMA customer detriment calculations not sustainable
 - Actual profit & other data consistent with broadly competitive market
- Suggests need for more challenge to (1) CMA analysis during investigation and (2) CMA approach to economic analysis
- Some possible ways to encourage challenge during investigation
 - Access to data room while CMA calculations changing
 - Wider public understanding of CMA analysis, with fewer excisions
 - 10,254 confidential items excised from CMA Energy Market Report
 - Widen basis of appeal to include CMA analysis, not just 'decision'
 - Encourage regulators to challenge CMA not just 'work with' CMA

Behavioural economics

- Has become increasingly influential
 - Ofgem Probe 2008 first major use of behavioural economics in UK?
 - 2013 CC/CMA revised Guidelines mentions 50 times
 - 2013 Govt Steer to CMA
 - “consumer behavioural issues should be central to the CMA’s analysis ... and inform the remedies”
- Merit: shows many conventional economic assumptions unrealistic
 - homo economicus is not homo sapiens
- And has led to useful operational suggestions
 - Behavioural Insights Team/Limited (Nudge Unit)
 - E.g. design of recent trial on Disengaged Customer Database (below)

Misuse of behavioural economics

- But instead of using behavioural insights to reform economics, economists have tried to reform people
 - Aim to turn homo sapiens into homo economicus
 - Attempt to correct for “behavioural biases” (eg loss aversion, status quo bias)
- Misleading policy implications
 - Inactive customers are seen as inferior
 - Markets require “confident customers, adept at exercising choice” (BIS 2010)
 - “Competition only works for active customers”
- Undue focus on weak customer response/engagement
 - CMA Energy Report 410 mentions
- Switching has become an obsession
 - CMA Energy Report 4785 mentions, CMA Banking Report 3162
- Focus on customer failure but little acknowledgement of regulatory failure
- Conclusion: Need to reorient behavioural economics to reforming economics rather than reforming customers

CC/CMA approach to competition

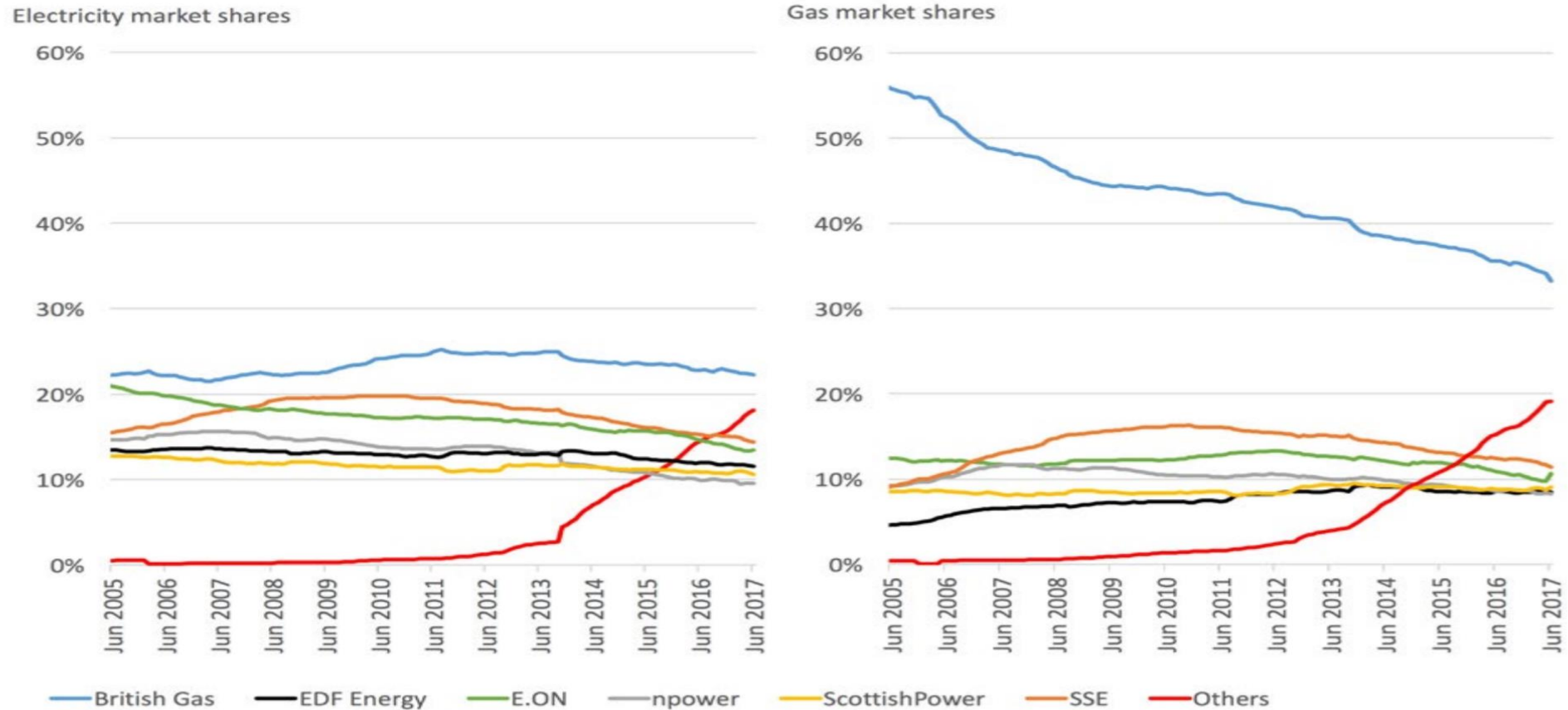
- UK competition authorities profess a dynamic view of competition
 - “the Commission sees competition as a *process of rivalry ... over time*”
 - the benchmark [against which to judge an actual market] is “*not an idealized perfectly competitive market.*” (Guidelines 2003/2013)
- But in practice CC/CMA reports do the opposite:
 - Little or no concept of competition as process over time
 - Benchmark basically idealised & static perfectly competitive market
- Why? Process isn't in economics textbooks, perfect competition is
- Revise CC/CMA definition to fit textbooks? No, revise textbooks
- This will require retraining economics profession? May be happening

The latest economics textbook

- *The Economy*, textbook by CORE, OUP 10 Oct 2017
 - “In response to student allegations of irrelevance of economics”
 - Note headings to Opening chapter
 - 1 The capitalist revolution 1.1 Inequality
- Competition as a process over time features explicitly
 - Schumpeter ch 2.5: the dynamism of capitalism, competition as process of creative destruction, the entrepreneur and innovation rents
 - Hayek ch 11: the dispersal of knowledge, meaning of competition as process of coordination, prices are messages
- But don't get too excited
 - about 500 Glossary definitions do not include Competition
 - but do include 50 references to Equilibrium

New entry has doubled since CMA study

Figure 2.2 Electricity and gas market share evolution

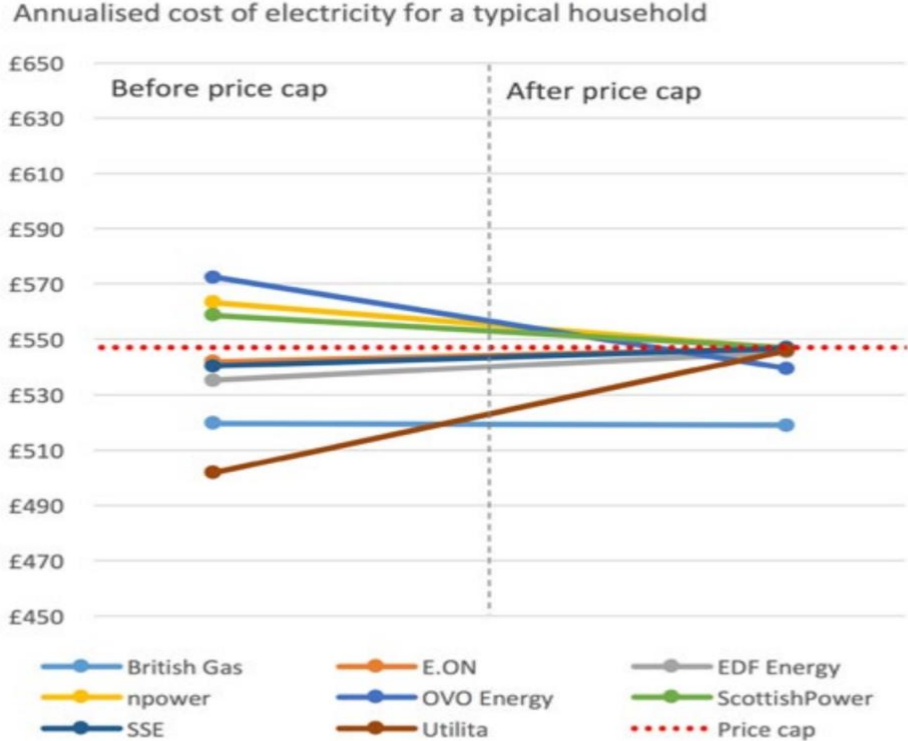
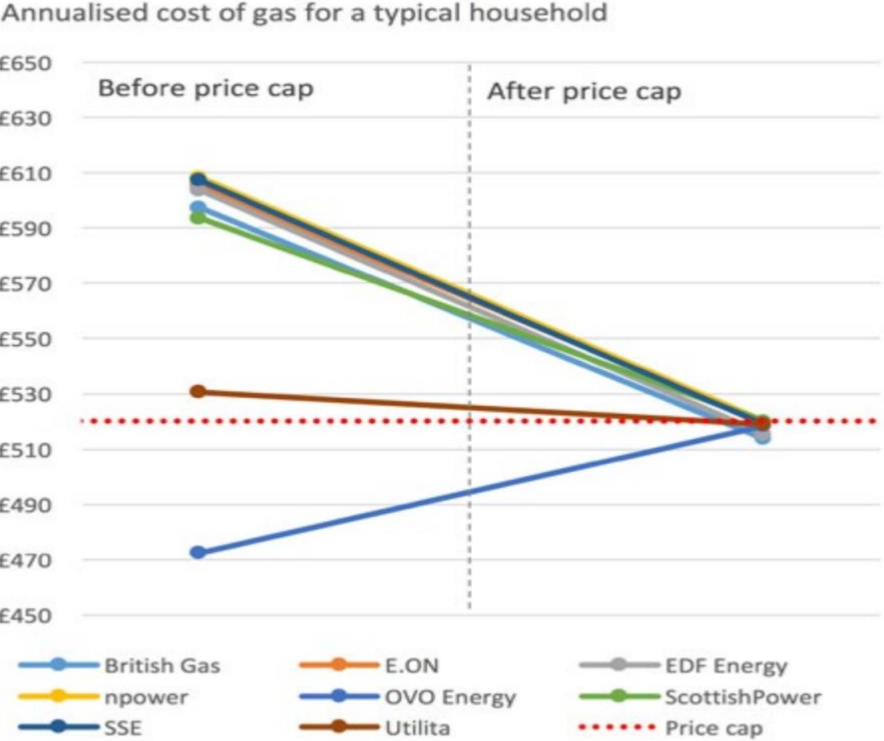


Note:
Data correct as of June 2017.

Source:
Ofgem analysis of Distribution Network Operators and Xoserve data.

Effect of price cap on PPM tariffs

Figure 2.13 Prepayment tariffs before and after the price cap



Note:
The chart shows each supplier's standard variable prepayment tariff only. These suppliers serve 90% of consumers using prepayment meters.

Source:
Ofgem's analysis of Energylinx data

Disengaged Customer Database trial (2400)

- Ofgem trial: Will disengaged SVT customers switch supplier or tariff?
 - 1/3 Sent 6 marketing letters from other suppliers 13.4% switched
 - 1/3 Sent 3 Best Offers Letter from Ofgem 12.1% switched
 - 1/3 Sent Nothing: control group 6.8% switched
- Average savings £131 per year
- Very few customers switched to suppliers they were sent info about
 - Many went to Price Comparison Website, more phoned own supplier
- Note: Timing atypical – c.f. controversial Big 6 price increases
- But even “disengaged” customers respond to price increases & prompts

Cheaper Market Offer Letter (CMOS) trial (138,000)

- Letter to SVT customers with 3 cheaper offers
 - personalised to customer usage, payment method, account management
- 1/3 Ofgem letter 2.4% switched supplier/tariff, saved £254 ave
- 1/3 Supplier letter 3.4% “ “ £255 “
- 1/3 No letter (control) 1.0% “ “ £164 “
- Greater impact of letter for customers over 3 years on SVT
- More external switching (supplier) than internal switching (tariff)
- Ofgem conclusion: Letter can prompt long-time SVT customers to switch, most effective from own supplier, & can increase savings

Lessons for Australia?

- Despite claims to contrary, UK retail energy market is not “broken”, CMA calculation of £1.4bn customer detriment is not sustainable, market is evolving over time, proposals for extensive price controls are not justified
- So present UK analysis & Govt proposal do not provide a model for Australia
- Check whether retail competition limited by wholesale mkt &/or vertical integration
- Check whether price increases really driven by inadequate retail competition
- Check whether prices & differentials really reflect excess profits
 - Price differentials could be evidence of competition, not market power
- Simple tariffs reduced competition. Focus on comparability & more informed choice
- Price controls stifle competition – against customer interests over longer term
- New: evidence how letters from suppliers increase switching & savings
- Best tariffs for vulnerable customers, info/nudges for less engaged, no price caps?