



AUSTRALIAN
ENERGY
COUNCIL

This is a reprint of a report produced by the Energy Supply Association of Australia (esaa).

SEPTEMBER 2015

Australian Energy Council



REGULATION OF RETAIL ENERGY MARKETS IN THE UK AND AUSTRALIA

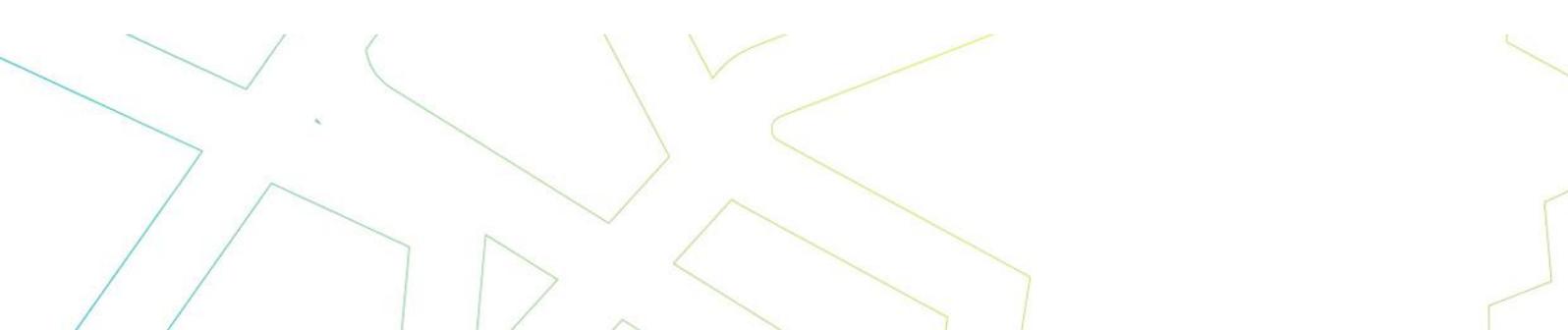
By Stephen Littlechild



About the Author

Stephen Littlechild is Emeritus Professor, University of Birmingham and a Fellow, Judge Business School, University of Cambridge.

He was a member of the UK's Monopolies and Mergers Commission from 1983 to 1988 and was UK Director General of Electricity Supply from 1989 to 1998. Since 1999 he has been an international consultant on privatisation, regulation and competition, especially in the electricity, telecommunications, airport and water sectors, and an economic adviser to several regulatory bodies.



Executive Overview

Some commentators are questioning whether those Australian retail energy markets that are now deregulated are fully competitive or whether there should be more regulatory intervention. There is even a suggestion that price controls should be reimposed, citing a recent proposal in the UK. What has been UK experience with such markets, and what, if anything, does UK experience have to say about regulatory policy in Australia?

Section I of this paper describes and appraises the development of retail energy regulation in the UK, leading up to the recent investigation by the Competition and Markets Authority (CMA). Section II draws on this experience to appraise some recent comments and suggestions in Australia, principally focussed on the Victorian market. This brief Executive Overview first notes some similarities and differences between the two markets and their regulatory policies, then highlights some of the main points in the paper.

The retail energy markets in the UK [strictly, Great Britain] and in Australia [Victoria, New South Wales, South Australia] have the following similarities:

- Both markets are now fully open to retail competition for domestic (residential) customers
- Regulators in both markets have actively promoted competition, while at the same time taking steps to deal with mis-selling (and in both markets major suppliers have ceased doorstep/doorknock selling)
- Both markets have seen active competition, including the entry of new competitors, innovations in tariffs, and customers switching between suppliers
- In both markets regulators have removed price controls in order to better promote competition
- In both markets there are now some concerns whether competition is sufficiently effective, whether prices and profits are too high, and whether certain price differentials are too great
- In both markets there are questions whether there should be more regulatory action to promote competition or protect customers, including the possibility of reintroducing a form of price control.

The main difference between the two markets is that Australia is still asking such questions, whereas the UK has actively intervened since 2008, after many years of deregulation during which many customers switched suppliers and diverse retail offers emerged. Specifically, the regulator Ofgem [Office of Gas and Electricity Markets] has variously introduced a prohibition on regional price differentiation, proposed (then later withdrawn) a provision for Ofgem itself to set a common standing charge for all customers of all suppliers, and sought to encourage more customer engagement by introducing strict requirements limiting the number and tariffs that suppliers can offer.

In addition, Ofgem tightened its regulation of direct marketing, including doorstep selling and telesales. A new marketing licence condition in 2009 was aimed at enabling customers to make well-informed choices. Ofgem was not satisfied with compliance, strengthened the licence condition and imposed heavy fines for non-compliance. The six major suppliers ceased doorstep selling in 2012.

The outcomes have not been as intended. Although new entrants have now taken over 10 per cent of the market, the customer switching rate (annual churn) has fallen by a half. Supplier profits have increased. Customers have lost a variety of tariffs that they valued. Tariff innovation and competition have been curbed. The CMA is now investigating the market and its provisional finding is that Ofgem's post-2008 retail regulations have had an Adverse Effect on Competition. It has proposed these regulations be removed.

However, the CMA has also found weak customer response in the market that could be exploited by suppliers. It has provisionally calculated that the major retailers have overcharged residential customers by £1.2 billion, or about 5 per cent. To address this

situation, it has recommended further measures to increase customer engagement, and also the introduction of temporary safeguard price controls, making reference to the price controls with headroom previously set in New South Wales (NSW).

The CMA's analysis and conclusions are controversial. I share the view of the major suppliers, that the CMA's characterisation of the market is not a fair reflection of the evidence it has received and published. Its benchmark is an artificial and imaginary market with hypothetically active customers, not based on real competitive retail energy markets. Its calculation of excess charges is obscure, and based in significant part on the assumption that the major suppliers have inefficiently high costs rather than high profits. The CMA underestimates the serious disadvantages of introducing price controls, not least in reducing the effectiveness of competition.

Given that customer engagement is not dissimilar in many other markets (banking and finance, insurance, telecoms, etc), the logic of the CMA's present diagnosis is a far-reaching shift towards more restrictive regulation and the wider introduction of price controls across many other sectors of the economy.

Turning to Australia, many states have now opened their residential energy market to retail competition. Competition has developed and regulators there have removed price controls. But several concerns have been expressed. In Australia's first deregulated market, Victoria, several recent analyses have questioned the effectiveness of competition by inferring excess retail profits and challenging the criteria for assessing competition. The three analyses critiqued in this piece are:

Dr Ron Ben-David, chairperson, Essential Services Commission (ESC), *If the retail energy market is competitive then is Lara Bingle a Russian cosmonaut?*, Presentation to NEM Future Forum, 25 June 2015

CME, *A critique of the Victorian electricity market: A report for the Brotherhood of St Laurence*, June 2015.

Mr Gerard Brody, CEO Consumer Action Law Centre, "Power price deregulation has failed", *Climate Spectator*, 31 July 2015.

I suggest that the conventional criteria for assessing competition, for example as used by the Australian Energy Market Commission (AEMC), are still suitable, and preferable to some suggested alternatives. Several of these conventional criteria, such as ease of new entry, number of retailers and increasing product differentiation, are consistent with a competitive retail market in Victoria. There are debates about the level of profits, and some calculate increases in retail profit margins in Victoria since price controls were removed. It is difficult to reconcile such calculations with the other criteria suggesting a competitive market. Some further clarification of the level and nature of retail profits would be helpful.

Mr Brody has noted the CMA's provisional report and advocates a similar price cap to benefit those who don't shop around. But this would increase the tariffs for those who do shop around, and generally reduce competition so that all customers are worse off. If there is a problem with competition in Victoria, which has not been established, price control ought to be the last remedy, rather than the first.

By contrast, Dr Ben-David and CME seem to be of the view that, over the long term, it is better to make the competitive market work. I agree. As they realise, smart meters and other technologies, such as rooftop solar and distributed generation, are changing the game. The Essential Services Commission (ESC) is therefore right to seek to bring about a more flexible, innovative and responsive market. Increasing competition, rather than increasing regulation, is the most effective way to protect the interests of customers.

Table of contents

Introduction	1
SECTION I: The retail energy market in the UK	2
1. The promotion of retail competition 1997 – 2008	2
2. Ofgem's Probe 2008.....	2
3. The non-discrimination condition 2008 – 2012	3
4. Restrictions on direct marketing and doorstep selling	4
5. The effects of Ofgem's Probe policies.....	5
6. Ofgem's Retail Market Review (RMR) 2011 and the Procrustean Bed	6
7. Ofgem's simpler tariffs.....	7
8. Why the change in Ofgem policy? External factors	7
9. The change in Ofgem's use of economists and economics.....	8
10. Competition and Markets Authority investigation: the effect of regulation	9
11. CMA analysis of weak customer response and market power	10
12. Critique of the CMA analysis of weak customer response and market power	10
13. Remedy 6: a proposed Ofgem price comparison website	11
14. Remedy 11: a proposed price control.....	12
15. More Ad Hoc Economics	13
16. Where now for the UK?	14
SECTION II: The competitive retail energy market in Australia	16
1. Introduction	16
2. The criteria for assessing a competitive market	16
3. Customer churn rates	17
4. Number of retailers and market shares.....	17
5. Product differentiation and customer response.....	18
6. Competition or competitive outcomes?	19
7. Persistence of two-part tariff structures.....	19
8. Pass-through of price shocks	20
9. Retail margins	21
10. Other arguments.....	22
11. Regulatory remedies?	22
12. Mr Brody's analysis	23
13. Conclusions	24

Introduction

Until 2008, the UK energy regulator Ofgem (Office of Gas and Electricity Markets) reported positively on the development of retail competition for residential customers. The UK was widely held to have the most competitive retail market in the world. Then suddenly Ofgem changed tack. It said that customers were not sufficiently engaged. Over the past seven years it has introduced prohibitions on price discrimination and severe restrictions on doorstep selling, proposed that it should set a common monthly standing (customer) charge for all suppliers, limited each supplier (retailer) to a maximum of four different residential tariffs per fuel, limited the variety of tariffs that could be offered, and prohibited most discounts.

In June 2014, Ofgem made a market investigation reference to the new Competition and Markets Authority (CMA). On 10 July 2015, CMA provisionally found that Ofgem's 'simple tariffs' regulations had had an Adverse Effect on Competition. But it went on to say that weak customer response gives suppliers market power, which they could exploit, and had exploited, through higher prices. To remedy this it proposed a transitional price control.

Meanwhile, many states in Australia too have opened their residential energy markets to retail competition. Regulators there have spoken highly of the development of competition and have removed price controls to further such competition. Yet occasional concerns are expressed about prices and profits, and customer engagement. And there has also been a suggestion to reimpose price controls as per the CMA's proposed remedy in the UK.

So, what is going on in the UK? And are price controls the best way forward for the UK and Australia? Section I of this paper outlines and assesses the development of retail energy regulation in the UK, and the CMA's ongoing investigation. Section II assesses some recent comments in Australia.

In general, my view is that Ofgem's regulation since 2008 has been misguided and counter-productive - customers have suffered rather than benefited. And while the CMA accepts this, its own analysis is subject to similar deficiencies. In particular, the CMA's proposed price control is worse than Ofgem's policies. Price control is NOT the solution, either in the UK or in Australia.

SECTION I: THE RETAIL ENERGY MARKET IN THE UK

1. The promotion of retail competition 1997 – 2008

Starting in 1997/1998, UK residential gas and electricity markets were opened up to full retail competition. The structure of the market, which had been changing in the decade or so since privatisation, continued to evolve. By 2002 British Gas (Centrica), the former national incumbent gas producer and supplier, had acquired generation capacity and become the largest residential electricity retailer [supplier], with 22 per cent of that market. The former 14 incumbent electricity retailers across the 14 regional areas had consolidated into five vertically integrated suppliers (that is, owning generation as well as retail operations, and in some cases, but not all, having distribution networks too). All the gas and electricity suppliers operated across all the regions. On average, former gas and electricity incumbents initially retained about two thirds of their former customers. There were occasional new entrants, most of them transient, until recently never supplying more than about 1 per cent of the market in aggregate.

In 2002 Ofgem deemed that competition was effective and abolished the temporary retail price caps put in place when the market was opened. Ofgem explained that competition could deliver more benefits for customers than regulation, and regulation could jeopardise competition, particularly regulation targeted to particular customer segments. Ofgem proposed to focus instead on use of competition and consumer law powers. A year later it outlined "Ofgem's substantial programme of work to remove continuing obstacles to competition (for example, reviewing the transfer process, tackling misselling (sic), reforming rules for objecting to switches, improving competition for dynamically teleswitched customers, as well as enforcing competition law)". It also sought to improve customer information and billing standards. It simplified the supply licence to rely as far as possible on general competition law and consumer protection legislation, and to encourage new entry. There were essentially no restrictions on what suppliers could offer or charge.

In 2005 a consumer group's "supercomplaint" on billing processes by a consumer group found the market was working well and proposed an Ombudsman and a prohibition on back billing to deal with some legacy problems in a proportionate way.

From 2002 to 2007, Ofgem issued several retail market reports. The reports noted the increase in competition. For example, in July 2007 Ofgem reported vigorous price competition for all customers; innovation by suppliers in terms of fixed and capped price deals, cheaper online deals and green tariffs; improving customer service; and customer switching rates at their highest in four years. The UK was widely held to have the most competitive retail market in the world. On 16 January 2008, responding to the Government and public concerns about price increases, Ofgem issued a press release headed 'Market is sound – Ofgem assures Chancellor'.

2. Ofgem's Probe 2008

Yet, one month later, on 21 February 2008, Ofgem issued another press release headed 'Ofgem launches probe into energy supply markets'. This was "to address mounting concern among customers that could undermine competition".

The Probe did not find excessive profits, and acknowledged that "the transition to effective competitive markets is well advanced and continuing". The Probe focused instead on how different types of customers were affected. It found that a relatively small proportion of customers were active and confident switchers, but the majority were not, with "around a quarter to a third of all customers being vulnerable in some way". Ofgem calculated that price differentials for different products and customers exceeded cost differentials by about £1 billion per year. It deduced that switching by the active minority was not driving down prices for inactive customers.

The Probe concluded that "the transition to competitive markets now needs to be accelerated". To that end Ofgem proposed a package of 20 new measures. These included actions to promote more active customer engagement and to help consumers make well-informed choices (for example, via more and better information), to reduce barriers to entry and expansion (for example, via suppliers publishing segmental accounts and by improving market liquidity), and to help small business consumers (for example, by clarifying terms and conditions, and accrediting switching sites). It specified Standards of Conduct, that remain subject to enforcement and fines. Of most immediate importance were proposed restrictions on differential pricing and stronger requirements (including via Standards of Conduct) on direct marketing and doorstep selling.

3. The non-discrimination condition 2008 – 2012

Ofgem's particular concern was differential pricing. "Until very recently, the five former incumbent electricity suppliers charged electricity customers in their former monopoly areas an average of over 10 per cent higher prices than comparable 'out-of-area' customers."... "A number of the price differentials between payment types¹ do not appear to have a cost justification."... "Overall, these price differentials mean that companies charge more to existing ('sticky') customers whilst maintaining competitiveness in more price sensitive segments of the market". To address its concern about what it now called "unfair" price differentials, Ofgem proposed that differences in charges by suppliers for different payment types must be cost-reflective.

Ofgem's *Probe Initial Findings* were put out to consultation. Even before this was complete and formal licence modifications were in place, suppliers began to adjust their prices to meet these prospective requirements. In December 2008 it was announced that "Ofgem's energy market probe is on track to remove more than £500 million in unfair premiums from suppliers' tariffs, but Ofgem wants speedier action".

Details of Ofgem's calculations suggest that this was not quite the full picture. As a benchmark of the competitive price, Ofgem used the standard dual-fuel direct debit (DF-DD) product supplied to 10.4 million out-of-area customers. By comparison with the DF-DD benchmark Ofgem calculated that various groups of other customers paid premiums totalling around £1 billion per annum. Ofgem then acknowledged that this annual premium exceeded the average annual margin earned by the Big 6 retail energy businesses between 2005 and 2007. Ofgem did not say what this average was, but it appears to have been about zero. Ofgem concluded that "if these differentials were eroded [as a result of regulatory action], it may be through a re-balancing between prices rather than by a straightforward decrease in price for the most impacted customers." Ofgem then calculated that, to rebalance the differentials while holding total revenue constant, "the annual cost of energy to a DF-DD customer would have to rise by around £40 per customer, or 3.5 per cent on the average dual fuel bill". Using this new benchmark, "the impact would fall from £1 billion to around £550 million". Ofgem said that "Although a rebalancing of this type would not reduce average prices paid by consumers it would disproportionately benefit vulnerable groups."

In short, some customers (including those vulnerable customers who were less active) would benefit by approximately £550 million, but other customers (including those vulnerable customers who were more active) would be worse off by around £550 million. It was a simple redistribution of income, although Ofgem did not present it that way.

But would a more competitive market actually be characterised by equal mark-ups over direct cost? Economic analysis (not acknowledged by Ofgem) was beginning to explain that competitive markets were often characterised by price differentiation, and indeed that competition might force suppliers to differentiate. Would suppliers actually rebalance prices so as to maintain the same level of total revenue? Independent economists submitted responses to challenge this. Professor George Yarrow, the economist Non-Executive Director on the Gas and Electricity Markets Authority (GEMA, the governing body of Ofgem) argued against the non-

¹ The three conventional payment types or methods are direct debit to a bank account, cash or cheque on receipt of bill, and prepayment via a top-up card.

discrimination condition, but failed to persuade his colleagues and resigned. In its Impact Assessment, Ofgem argued that the impact on competition was ambiguous, but said it "attached more weight to the benefits to vulnerable customers".

Non-discrimination condition SLC25A was formally implemented in September 2009. It had a sunset clause, so that it would fall away in three years unless reimposed. In 2012 Ofgem initially proposed to renew the condition for a further two years, without having conducted a promised review of its effect. Eventually, Ofgem decided to let the condition lapse, but with a strong warning to suppliers not to resume differential pricing.

4. Restrictions on direct marketing and doorstep selling

All the major energy suppliers used so-called doorstep selling as a cost-effective means of reaching potential customers. From the time of market opening until 2008, Ofgem and its predecessors drew attention to the potential benefits of doorstep selling as a source of information for customers, particularly vulnerable customers. But they also noted and responded to concerns about selling malpractices by introducing and strengthening marketing licence conditions to protect customers against misleading and high-pressure salesmanship. Ofgem's view until 2008 was that these conditions could be removed in due course, leaving the energy market subject to general customer protection legislation.

In 2008, following its Probe, Ofgem radically changed its regulation of energy marketing activities, including doorstep selling and telesales. It adopted a more ambitious aim: not merely to prevent misleading information, but to enable customers to make well-informed decisions. Its new proactive approach involved overarching standards of conduct and more extensive and more severe obligations on suppliers. Thus, "information provided during the sales process should be complete and accurate, understandable, appropriate and not misleading; and sales activities should be conducted in a fair, transparent, appropriate and professional manner". This objective would apply to telesales, as well as face-to-face marketing activities.

The new marketing condition came into effect around the end of 2009. In September 2010 Ofgem opened several investigations into suppliers' compliance practices. In March 2011, Ofgem found "Poor supplier conduct: Questionable supplier behaviour and inadequate response to remedies introduced following the Probe, has contributed to a broad mistrust of suppliers and anxiety amongst consumers". Ofgem was not satisfied with suppliers' compliance with the new marketing condition. It proposed an even stronger, more prescriptive licence condition, with enhanced monitoring and enforcement including naming and shaming.

This new regulatory approach increased the cost and risk of direct marketing. It was also burdensome on customers: one supplier said that the requirement of confirmation telephone calls to the customer could take up to half an hour. The new marketing condition was a major factor in the decisions of major suppliers to abandon doorstep selling, and other forms of direct marketing, (such as, in supermarkets). It was not the only factor – some suppliers were concerned about the nature of the customers acquired in this way; the quality of a direct sales force was difficult to monitor and manage; and there was also growing opposition from consumer organisations and some politicians. Nevertheless, although sometimes problematic, these direct marketing approaches had assisted vulnerable customers to benefit from the competitive market.

In July 2011 one major supplier abandoned doorstep selling. By October 2011, four more suppliers followed suit. In May 2012 Ofgem announced a penalty of £4.5 million on one supplier for breach of doorstep and telesales regulation. The last (smallest) major supplier ceased doorstep selling in July 2012. Fines or penalty payments against five major suppliers totalled £39 million.

5. The effects of Ofgem's Probe policies

Initially, the average customer switching rate (churn) had steadily increased, from about 15 per cent annually in 2003 to 20 per cent annually in 2008. Then it suddenly reversed and started falling, eventually to about 10 per cent annually in 2012, half the previous level in 2008. It has remained at about that level ever since. Only two explanatory factors have been suggested: the non-discrimination condition and the new marketing condition that led to the cessation of doorstep selling and direct marketing. Which factor is more responsible is a matter of conjecture: the main suppliers may have begun to reduce direct marketing from 2008, but most did not cease doorstep selling until mid 2011, by which time the switching rate had fallen to about 15 per cent, before it fell more steeply the next year. (And the customer switching rate has remained high in Australia despite the cessation of direct selling there.)

Such a reduction in switching surely reduced competitive pressure in the market. In addition, it impacted more strongly on customers that responded to doorstep selling. Thus, before 2008 Ofgem reported that participation in switching was evenly spread across the different socio-economic groups, while more recently the participation rates have fallen for socio-economic groups D and E.

The non-discrimination condition had an immediate impact in terms of reducing (nearly halving) regional price differentials (the remaining difference being considered to reflect cost differences). However, at about the same time there was a large increase in the average energy bill and in net profit margins. Ofgem's newly prescribed segmented accounts are not available before 2009, but they show that in the domestic (residential) market, earnings before interest and tax (EBIT) increased from £233 million in 2009 to £1,190 million in 2012, an increase of nearly £1 billion in profits. The CMA reports that in Domestic Supply, total EBIT for the Six Large Energy Firms combined was £110 million in 2007 and minus £6 million in 2008, then increased to £379 million in 2009, to an average of £785 million over the next two years then to an average of £1,180 million in 2012 – 2013.

Both sets of figures suggest that suppliers did not reduce the "unfair price differentials" as Ofgem envisaged, by reducing the higher prices by about £500 million in profits and increasing the lower prices by about £500 million in profits. Rather, as economists and critics predicted, the outcome was more consistent with suppliers simply increasing their lower prices, perhaps by nearly £1 billion in profits. Other factors may, of course be relevant, but it is regrettable that neither Ofgem, nor the CMA, has shown any interest in assessing the impact of Ofgem's regulation on the level of prices and profits in the sector.

It cannot be assumed that only the more active customers suffered, and that the less active customers – or the more vulnerable customers (not necessarily the same) – were no worse off. Suppliers' competitive tactics changed in several respects, for example, with the introduction of prompt-pay discounts, and more use of online tariffs and time-limited tariffs to attract new customers. Ofgem reported that the number of available tariffs increased by over 70 per cent from January 2008 to January 2011, mainly in the number of fixed tariffs and other options including "features such as air miles, retail rewards, financial offers, capped prices, energy credits, a tracker energy price or smart metering options". Presumably, the more active customers would be more responsive to such new offers. It therefore seems doubtful whether Ofgem's policy improved the relative position of the less active or more vulnerable customers. They were as likely to be made worse off as more active ones. Indeed, insofar as more vulnerable customers were now less likely to switch in the absence of doorstep selling and direct marketing, they could well have been made relatively worse off.

Ofgem's policy seems to have weakened competition in other ways, not only by limiting regional price differentiation. For example, it contributed to a significant reduction in rivalry between the two largest suppliers. From January 2004 to June 2008, SSE became the second largest supplier by increasing its shares of the electricity and gas markets by 14 percentage points at the expense of the largest supplier (British Gas), whose shares fell by a total of 17 percentage points. SSE has since indicated that Ofgem's 2008 policy caused it to change its aggressive pricing policy in the gas market. From June 2008 to June 2012 SSE gained a further 2 percentage points and British Gas lost only 1 percentage point. Indeed, market shares of all the large suppliers have remained relatively constant since 2008.

There has, however, been an increase in the number and market share of new entrants, up from about 1 per cent until 2008 to about 10 per cent in 2015. There seem to be three possible reasons. This may be because small suppliers (with under 250,000 customers) are exempt from certain environmental and social policy costs, which are relatively significant in relation to the size of the profit margins in

the market. Only a few small suppliers have now exceeded this limit. It has also been suggested that lower wholesale prices give entrants buying in recent years an advantage over incumbents that have typically spread their wholesale purchases over several years. A third possible factor is that the higher industry prices and profit margins have made it more profitable for new suppliers to enter the market, compared to the situation before the non-discrimination clause was enacted. New entry is what one would expect if profits increase in a competitive market, and the variety of products and services offered by the new entrants is very welcome, so these are signs that the competitive market is working. But as a result of Ofgem's regulation it seems to be working at a higher overall level of industry profit margins, and hence prices to most customers, than was the case before 2008.

6. Ofgem's Retail Market Review (RMR) 2011 and the Procrustean Bed

In 2010, Ofgem noticed a 38 per cent increase in net retail margins and decided to review the retail market again. In March 2011, its Retail Market Review (RMR) found that, although some large unjustified price differences had been removed, there had been a deterioration in the market in other respects. It noted the reduction in customer switching – what it described as “an increase in the number of passive consumers and fall in the number of active consumers” - and attributed this to complex pricing structures and an increase in the number of tariffs available.

To address this situation, Ofgem proposed to strengthen various Probe remedies, and also to take new measures “to make it far easier for domestic customers to compare prices and get a better deal”. These measures focused particularly on Standard Variable (evergreen) Tariffs, on which most residential customers were (and still are) supplied. Standard tariffs comprise a monthly or quarterly fixed charge (commonly called a standing charge, or a customer charge) plus a unit or usage rate (in pence per kWh) applied to the amount of energy consumed. This tariff is variable in that it can be modified at the supplier's discretion, subject to a 30 day period of notice for an increase. Evergreen means that the tariff is for a period of indefinite length: there is no specified termination date as there is for a fixed-price fixed-term contract.

Ofgem's proposal was "to restrict the number of tariffs for standard evergreen products from each supplier to only one per payment method. We also propose to standardise the format of these tariffs across suppliers, with suppliers allowed to compete on a single 'per unit' price. Consumers would then be able to tell at a glance whether they can save money either by switching supplier or by moving to a new deal. This would be a major reform impacting the 75 per cent of customers currently on standard evergreen products". This was, incidentally, a policy that Ofgem had considered and rejected just two years earlier.

In December 2011, Ofgem clarified that it would set the uniform standing charge. I referred to its proposal as Ofgem's Procrustean Bed. Those suppliers whose monthly fixed charge was above Ofgem's uniform fixed charge would have it reduced; those whose fixed charge was below this level would have it increased. All suppliers' tariffs would thus be cut or stretched to fit this Procrustean Bed.

Ofgem adduced research that customers would be more likely to engage and switch if this policy were in effect. I argued that this seemed implausible. Uniformity would be inconsistent with the flexibility, innovation and personal tailoring of terms associated with the proposed introduction of smart metering. Uniform standing charges would also have a number of significant disadvantages. For example, they would preclude tariffs with zero standing charge that were valued by important groups of customers, especially old age pensioners. They would increase the costs and risks to suppliers, who would be unable to modify a significant component of their revenue in response to changing circumstances. Complying with and enforcing the policy would increase regulatory costs, and in turn be paid for by customers. Setting energy prices would once more become the responsibility of the regulator, hence there would be more lobbying by suppliers and customer groups. Energy pricing would once again become a political decision, rather than the outcome of a competitive market.

In October 2012, Ofgem changed tack, having “listened to concerns” and recognised some “practical difficulties”, though it did not explain what these concerns and difficulties were. It simply abandoned its proposal to set uniform standing charges and proposed an alternative way to simplify tariffs.

7. Ofgem's simpler tariffs

Ofgem's replacement proposal was that each supplier should be limited to a maximum of four tariffs per fuel per payment method. All tariffs had to have a simple two-part structure: a standing charge and one unit rate. The standing charge could be zero, but the unit rate could no longer vary with the level of consumption (that is, declining block tariffs were prohibited). Discounts were only allowed if expressed in pounds, not as percentages. Customers on tariffs no longer available to prospective customers (“dead tariffs”) were required to be moved to that supplier's cheapest live or open tariff. With some modifications (for example, to prohibit all but two kinds of discount) these tariff restrictions generally came into effect on 1 January 2014, although most suppliers had adjusted their range of tariffs earlier.

There were predictable consequences. Suppliers naturally chose to keep their most popular and profitable tariff types and phase out their innovative and minority preference tariffs. They substantially withdrew green tariffs. Supplier E.On had to withdraw its StayWarm tariff that offered customers over 60 years of age a fixed monthly bill regardless of how much energy the customer used (though the bill could be adjusted on a forward-looking basis depending on actual usage). Supplier SSE had introduced a new tariff that, for several months, price comparison websites deemed “the best offer in the market”. That tariff was prohibited because the discount was greater in the first year than in the second. Introductory and “cash-back” discounts that some suppliers used were banned. Prompt payment discounts and all but two other types of discounts were prohibited too. By 2014 the major suppliers had limited themselves to one standard variable tariff and two or three fixed-price tariffs for different periods ahead.

Ofgem's justification for such restrictions was that simpler tariffs would enable and incentivise customers to engage more in the market. In practice the allowed number and variety of tariffs still seemed confusing to customers. One survey suggested that although customers preferred simpler tariffs other things being equal, they did not prefer simpler tariffs if it meant, for example, a prohibition on discounts. Research by Ipsos Mori for Ofgem reported that 77 per cent of non-switchers were happy with their current supplier, 22 per cent said switching was a hassle, and 20 per cent said there wasn't much difference between the suppliers to make switching worthwhile. None of the non-switchers said that complexity of tariffs was a reason for not switching.

Ofgem focused on tariff complexity to the exclusion of other considerations, such as sensitivity to prices and brand loyalty. But Ofgem's own earlier research had found that “the largest single factor affecting a supplier's customer churn rate is its relative price, and ... the level of marketing expenditure is very similar to price in its effect on a supplier's churn rate”. This explains the marketing expenditure by price comparison websites that enable switching (there are nearly a dozen such authorised websites in the UK, as well as many unauthorised), as well as by energy suppliers themselves. It is common to see advertisements such as “Compare your energy bills and save up to £294!” or “Free wine when you switch”. Ofgem's policy was thus inconsistent with empirical evidence. It assumed that regulators know more about what motivates customers than the suppliers and price comparison switching sites that need to discover and provide what customers want if they are to survive in the market.

8. Why the change in Ofgem policy? External factors

Ofgem's policy since 2008 has been dramatically different from its policy before that date, and by no means successful. What made Ofgem change direction? There is no clear answer, but three factors might be relevant: energy prices, government policy and Ofgem's attitude to economics.

First, this was a period of significantly increasing residential energy prices. For two full decades, from about the mid-1980s to the early 2000s, the UK enjoyed domestic energy prices steadily falling by about one third in real terms over that period, the most benign such period in living memory. Over the next five years energy prices nearly doubled in real terms - the steepest and most sustained increase in living memory. Finally, in the subsequent five years they fell significantly, before increasing again - the most erratic fluctuation in living memory. There were particularly large increases – around 15 per cent - in retail prices in the first quarter 2008.

Regulators and governments feel the need to “Do Something” when customers are concerned about prices, regardless of whether they are actually in a position to improve the situation. It has subsequently become clear that the main causes of the significant retail price increases were increases in international fuel costs, increases in regulated transmission and distribution use of system charges, and increasing costs of Government obligations on the energy sector as part of its social climate change policy. But the Government had no particular interest in clarifying this. It was often more convenient to imply that energy suppliers were the problem, and that stricter regulation of them was the way to ameliorate the problem. From February 2008 onwards that is broadly what Ofgem and the Government suggested.

A second factor was a change in government policy in 2008. Conservative Governments from 1979 to 1997 explicitly rejected the concept of an energy policy. Labour Governments from 1997 to September 2008 diluted the duty to promote competition, gave the sector regulators additional duties, and took powers to guide the sector regulators in their discharge of these duties. Otherwise, however, they left the industry to the regulator.

In contrast, the Labour Government from October 2008 to April 2010, with Mr Milliband as Secretary of State for Energy and Climate Change, had a much more interventionist perspective. Within five months he had announced a “complete rewrite of UK energy policy”, and indicated that important decisions could not be left to the market. He gave strong support to Ofgem’s proactive policy in the retail market. The Energy Act 2010 required that before Ofgem took action to promote competition it should look first to more active regulation. The Coalition Government 2010-2015 (with Liberal Democrat energy ministers) broadly continued this interventionist policy. It saw regulation as part of the process for avoiding unnecessarily high prices. It imposed an additional requirement on Ofgem to further the delivery of the Government’s policy outcomes. It supported Ofgem’s policy (the Prime Minister actually indicated a wish to go further). In order to discourage resistance and to get prices down earlier, the Energy Act 2013 gave the Government power to require suppliers to do the kinds of things that Ofgem was proposing

9. The change in Ofgem's use of economists and economics

The third factor is the changing nature of Ofgem's approach to regulation, particularly as reflected in the deployment of economists at Ofgem and its governing body GEMA (the Gas and Electricity Markets Authority, appointments to which are made by the Secretary of State, in practice after consultation with the Chairman.) In 2013 the retiring Chairman paid tribute to the retiring Chief Executive's "energetic, expert and transformational role in leading Ofgem from a body that was essentially an economic regulator 10 years ago to its current and far more multi-dimensional purpose and activities". Three aspects will indicate this evolution away from economic regulation:

1. From Ofgem's inception in 1999 until the end of 2007, the Head of Markets Division, responsible for retail regulation, was a trained economist. The new appointee at the beginning of 2008 was not an economist, and remained in place until 2013, when he became acting Chief Executive.
2. From 1999 to 2003 the Chairman, Chief Executive, Head of Markets Division and one Non-Executive Director were trained economists. From 2004 to 2008 two of them were, and by the end of 2010 none of those four posts were filled by economists.
3. From 2001 to 2008 the Non-Executive Directors were all from a business/finance/economics background. By 2013 Non-Executive Directors with such a background were in a minority.

Ofgem's self-chosen move away from being an economic regulator is consistent with its use of what might be called Ad Hoc Economics instead of conventional economics.² Examples include the reliance on surveys of what customers say they would do rather than on evidence of how they actually behave, the implicit belief that effective competition is characterised by equal markups over cost for all products, the blurring of the distinction between how markets work and how they ought to work or how the regulator would like them to work, the emphasis on "fair" prices, the deafness to professional economic advice on the non-discrimination rule, the lack of interest in testing the predicted consequences of that rule, the belief that making tariffs simple would increase involvement, the failure to recognise that limiting the number and types of tariffs constitutes a restriction of competition, the belief that severe restrictions could be imposed on suppliers without adverse implications for competition and customers, the guiding concept of a "vision" of a successful energy market, and so on.

10. Competition and Markets Authority investigation: the effect of regulation

It is argued above that, in practice, this new approach exacerbated rather than ameliorated the pressure of rising prices and the situation of vulnerable customers. Concerns about the energy market persisted. In late 2013, the Government announced that Ofgem and the competition authorities would jointly carry out a competition assessment of the retail market. In March 2014, this assessment identified a number of features of the market that might have an adverse effect on competition. In June 2014 Ofgem referred the residential retail energy sector for a market investigation by the new CMA, which is the joint successor body to the former Office of Fair Trading and Competition Commission.

The CMA's Summary of Provisional Findings finds that numerous important aspects of the market are generally not a problem. However, certain more detailed aspects of the sector have an adverse effect on competition.³

The CMA then investigates the impact of regulation. It notes that "Over the last six years, three major interventions by Ofgem have changed the nature of retail competition significantly". (1) The regional non-discrimination condition likely contributed to a softening of competition on the Standard Variable Tariff. (2) The introduction of new licence requirements, standards of conduct and enforcement action resulted in the withdrawal of the Six Large Energy Firms from doorstep selling in 2011 and 2012. (3) Since the introduction of Retail Market Review (RMR) reforms in 2014 there are "few signs that customer engagement is improving materially". On the contrary,

146. Overall, our provisional finding is that the 'simpler choices' component of the RMR rules, (including the ban on complex tariffs, the maximum limit on the number of tariffs that suppliers are able to offer at any point in time, and the simplification of cash discounts) is a feature giving rise to an AEC [Adverse Effect on Competition] in the retail supply of electricity and gas to domestic customers, through reducing retail suppliers' ability to innovate in designing tariff structures to meet customer demand, in particular, over the long term, and by softening competition between PCWs [Price Comparison Websites].

The CMA's proposed Remedy 3 is to remove the 'simpler choices' component of the RMR rules. Ofgem has accepted this verdict, saying "we respect the CMA's view".

² The term is inspired by what David Henderson has called Do It Yourself Economics: "firmly held intuitive ideas and beliefs which owe little or nothing to textbooks, treatises or the evidence of economic history." This typically involves "a view of market processes as anarchic, amoral, ineffective and biased against the weak. This view does not involve a conscious rejection of the orthodox economist's vision of reality, but rather a lack of awareness of what this vision comprises." P D Henderson, *Innocence and Design*, The Reith Lectures, 1985.

³ The non-problematic areas include the wholesale electricity and gas markets, the self-dispatch system in electricity, vertical integration and tacit coordination. The problematic areas include the absence of locational prices for transmission losses and constraints, the government's mechanisms for allocating Contracts for Differences (CfDs) related to renewables, the absence of a plan for moving to half-hourly settlement in the domestic electricity market, a lack of robustness and transparency in regulatory decision-making, and aspects of regulatory code governance.

This is, however, a damning indictment of Ofgem's retail regulation since 2008, and in particular of its Ad Hoc Economics. Instead of promoting competition and better protecting customers, Ofgem's policy has reduced competition and made customers worse off. The consequence has not simply been a reduction in variety and choice of tariffs: it has surely also meant higher prices to customers, including vulnerable customers.

11. CMA analysis of weak customer response and market power

The CMA's finding about Ofgem's regulation is plausible and the proposed remedy desirable. However, the CMA does not leave the analysis there.

It argues that gas and electricity are "necessity goods". Also, "Gas and electricity are extreme examples of homogenous products in that the energy that customers consume is entirely unaffected by the choice of retailer. We would expect, therefore, that price would be the most important product characteristic to a customer in choosing a supplier and/or tariff". This would characterise competition "in a well-functioning retail market".

However, the CMA says that this is not how customers behave. It finds that "there were significant gains from switching that went unexploited by domestic customers" and claims that this "provides evidence of weak customer engagement in the domestic retail markets for electricity and gas in Great Britain". The CMA examines further the nature of the disengaged customers. "The survey results also suggest that those who are have low incomes, have low qualifications, are living in rented accommodation or who are above 65 are less likely to be engaged in the domestic retail energy markets."

The CMA is thus led to argue that the problem in the energy market lies with customers. "... in retail energy markets, competition requires a good level of customer engagement in order to be effective, in particular customers need to respond to price differentials by switching their custom to cheaper suppliers." Consequently, there is "an Adverse Effect on Competition through an overarching feature of weak customer response".

This, "in turn, gives suppliers a position of unilateral market power concerning their inactive customer base and gives them the ability to exploit such a position through their pricing policies." Did suppliers exploit this market power? The CMA says that "In a well-functioning competitive market we would generally expect to see returns broadly in line with the cost of capital over the long term." It calculates that suppliers earned a higher profit than the cost of capital, but also observes that there were differences in unit costs, "which suggest that some firms may not have operated efficiently". Attempting to control for these cost differences, it estimates "a competitive benchmark price level that would have allowed firms to recover efficient levels of costs and earn a fair rate of return on capital employed". On this basis, "average prices offered by the Six Large Energy Firms over the period 2009 to 2013 were around 5 per cent above the competitive level in the domestic [residential] segment, and around 14 per cent in the SME [Small and Medium Enterprise] segment. This equates to domestic customers paying around £1.2 billion and SME customers paying around £0.5 billion more on an annual basis than would have been the case had competition functioned more effectively".

12. Critique of the CMA analysis of weak customer response and market power

Each of the steps in the CMA's analysis is problematic. For example, in a physical sense gas and electricity supply may be homogenous, but that is not how customers see the situation. For customers, there are potentially significant differences relating to type and level of tariff, means and timing of payment, quality of service and any other benefits provided (or not provided), customer interface, marketing activities, trust or otherwise in the retailer, and not least of all familiarity and past history of relationships between the supplier and the customer. The relevant choice that the *customer* makes *is* affected by the choice of retailer.

Not surprisingly, therefore, the CMA's expectation that price would be the most important product characteristic to a customer in choosing a supplier and/or tariff is not always consistent with evidence on how customers actually behave. More precisely, price may well be the most important product characteristic to those customers who are actively contemplating changing their supplier, or who are actively looking to reduce their energy bill, or indeed to those customers whose eye is simply caught by the offer of a significant price reduction. But price is evidently not the most important characteristic to the many other customers who choose to remain with their current supplier or tariff even when it is not the cheapest in the market. An Ofgem customer survey produced a striking example of this: 70 per cent of customers said they did not trust other suppliers but they did trust their own supplier.

The CMA presents no evidence that customers are less engaged in the retail energy sector than in other sectors, or that the available price differences are greater in energy than elsewhere. A number of the major suppliers have challenged the CMA's claims, and the CMA's representation of the available evidence on customer engagement. Suppliers have also challenged the CMA's calculation of excess profits and inefficient costs. The following three additional observations might be made.

First, the CMA seems to assume that in a competitive market, all firms would have the same costs as the lowest quartile company, and that any cost in excess of this is a result of a lack of competition. This is implausible.

Second, although the CMA has found that Ofgem's regulatory policies since 2008 have restricted competition, and there is reason to believe that this led to a higher level of profits than would otherwise have been the case, the CMA takes no account of the possibility (indeed, likelihood) that profits would be lower if, as it recommends, these regulatory policies were rescinded.

Third, the CMA is concerned about some increasing differentials between tariffs paid by engaged and less engaged customers, but fails to acknowledge that this is another likely consequence of Ofgem's regulatory policies. For example, the requirement that customers should be put on, or advised of, the supplier's best available Standard Variable Tariff (SVT) has effectively meant that suppliers can only offer one such tariff, and hence (as the CMA acknowledges) the SVT is no longer used as a means of attracting new customers. Again, the rescinding of this regulatory policy can be expected to go some way to addressing the CMA's concern.

13. Remedy 6: a proposed Ofgem price comparison website

To address the Adverse Effect on Competition of weak customer response and supplier exploitation of market power, the CMA proposes several remedies. Two are of particular concern: Remedies 6 and 11.

Remedy 6 is that Ofgem should provide an independent price comparison service. The purpose would be to increase trust in price comparison websites, and thereby encourage greater use by customers.

The belief that an Ofgem website would increase customer trust is implausible. The very setting up and advertising of such a site would announce to customers that Ofgem regards the service provided by PCWs as untrustworthy. If anything, the proposal would reduce customers' trust, not increase it.

The CMA is right that "PCWs are an important means by which effective competition can develop in the domestic retail markets". If there were no such price comparison websites in the UK things might be different. But the UK seems to have more, and more effective and innovative, price comparison sites covering the energy sector than any other country in the world. This seems to be an extremely competitive and successful market. There has been no suggestion that other sites do not accurately list the offers of suppliers, and many sites are now claiming to list all the offers available. How then can one justify introducing yet another site run by the regulator and presumably paid for by a levy on suppliers and hence on customers? This in itself could be anti-competitive; indeed, the CMA asks whether this service could undermine the development of other PCWs. I note that in Australia, for example, there are two government-run comparison websites in the energy sector (one for Victoria and one for other states), but relatively few commercial sites.

The CMA seems to consider that a regulatory website would be more authoritative than other websites. In practice, however, some sites run by regulators (for example in the US) have difficulty in funding the kind of service that customers want. Nowadays, a successful, accurate, up-to-date, flexible and customer-friendly comparison website is an expensive proposition. The CMA has acknowledged that it may well not be practicable for any website to list all offers in the foreseeable future. The notion that a regulatory website can provide an authoritative picture is increasingly illusory.

At the time of domestic market opening around 1998, regulators Ofgas and Offer made conscious decisions not to operate a comparison website, but at the same time encouraged other parties to do so. That has been the firm policy of successor regulator Ofgem ever since, and it has proved successful in encouraging a vibrant and effect PCW sector.

14. Remedy 11: a proposed price control

Remedy 9 is to provide customers with different or additional information. However, the CMA considers that these and other measures may take time to have effect. Moreover, "We observe that previous interventions in retail energy markets appear to have had limited success in engaging inactive customers. Therefore, our current view is that any new remedies to prompt engagement may need to stretch beyond the provision of information in order to achieve their goal." So Remedy 10 is described as measures to prompt customers on default tariffs to engage in the market, but the CMA has no concrete proposals to make: it simply invites parties to make suggestions.

But even prompting may not be effective. "For those customers who fail to respond to either the enabling measures set out in Remedies 3 to 9, or to the prompts set out in Remedy 10, our current view is that ... these customers would move on to a safeguard tariff." Remedy 11 is thus price control: a transitional safeguard regulated tariff set by the CMA or Ofgem. Suppliers would no longer be allowed to offer the present standard variable tariffs, or any evergreen tariff.

The CMA says that to set the safeguard tariffs in the same way as the standard RPI-X network price controls "could have severe repercussions for customers". The safeguard tariff would therefore need to include some "headroom". However, the level of the tariff is very important. "If it is set tightly, it will have a damaging impact on competition, undermining incentives for customers to engage in the markets. On the other hand, if set at too high a level, then at best it will provide no protection to customers, and at worst potentially provide a higher focal point for default prices to settle." The CMA then says "Such an approach [presumably referring to setting a safeguard tariff with headroom] has been used in New South Wales in Australia, and we are currently reviewing that example, both in terms of the approach used and the impact on the market."

The proposed safeguard or default tariff has serious disadvantages. The CMA rightly recognises that "If it is set tightly, it will have a damaging impact on competition, undermining incentives for customers to engage in the markets." But it would be false to assume that if it is set at a more moderate level this will not have an adverse effect on competition. On the contrary, *any* enforced reduction in present tariffs will make a rival supplier's offerings less attractive. It will thereby reduce the ability of new entrants to compete and reduce the incentive for customers to engage. It will send the message that customers are henceforth to be protected by regulation, not by competition or by their own actions.

Thus, in practice, reintroducing price controls will not protect customers while the CMA's other remedies take effect and while these customers gradually become more engaged. Rather, by actively restricting the growth of competition and discouraging customer involvement it will militate against the working of these other remedies. It will defer the day when (in the CMA's view) customers are fit to be allowed to engage in the market unsupervised. Reintroducing price controls will also increase regulatory uncertainty, hence the cost of capital. Customers will, of course, pay for this higher cost.

The proposed remedy ignores the practical and political considerations associated with price controls. There is no simple – or even complex – way to determine a "right level". There will be great pressure to set and reset the price control toughly, to demonstrate that

it is of benefit to customers. The existence of prices in the market lower than the default price will be taken as a sign that the regulator has not been tough enough. There will be pressure to continue and tighten the control, little or no pressure to remove it. This is particularly the case in present conditions, when energy bills have been rising, competition is questioned and Ofgem has a duty to look for regulatory solutions before promoting competition. A price control, once reintroduced, would be extremely difficult to remove, despite the CMA's intention that it be transitional.

The CMA refers to experience in NSW. However, the situation there is quite different from the UK. A price control with a headroom above cost, followed by a transitional (two year) tariff, was used in NSW as a way of *removing* pre-existing price controls, not as a means of *reintroducing* price controls in an already competitive and unregulated market. The important message from NSW is that the regulator there has advised *against* price controls. They may seem to protect certain customers and attract some political support, but in doing so they restrict rivalry, innovation and improvements in retail competition, to the disadvantage of customers generally. The NSW regulator considered that the distinction between regulated and market prices confused customers and distorted the market. For these reasons, regulators in NSW and in other competitive energy markets in Australia are strongly opposed to retail price controls. NSW experience and policy are thus not a blueprint for price controls, but on the contrary suggest that reintroducing price controls would be counter-productive.

15. More Ad Hoc Economics

Instead of looking at how competitive markets actually operate – the CMA studiously avoids looking at any real competitive markets in the UK or around the world - the CMA uses the benchmark of what it would expect competition to be like in a “well-functioning market”. Consumer preferences are imagined rather than observed. Assumed well functioning costs and profit rates reflect the theoretical ideal of a perfectly competitive market in long-run equilibrium rather than in a rivalrous discovery process where some competitors have not yet discovered how to be as efficient as others. Using that model, the CMA simply imagines what it thinks competitive retail energy markets *should* look like – in effect, what it wants them to look like, what it thinks would be “nice to have”.

The CMA's claim that "competition requires a good level of customer engagement in order to be effective" reflects a contentious use of the term "effective". It seems to mean "in order that those customers who are not active in the market should pay about the same price as those who are". But if customers have different costs of time, and different preferences, a competitive market will not lead to similar prices.

Economists may differ in their preference for seeing competition as a state of equilibrium or as a process over time. But they surely agree that competition is a vehicle for meeting customer preferences. The CMA does not accept this: it considers that, with respect to the energy market, most customer preferences are wrong: it implies that some customers are inadequately informed, some are too focused on other things, some are too lazy. In particular, the 70 per cent of customers that are presently on Standard Variable Tariffs are wrong-headed. One might interpret these customers as saying something like, "We have not yet seen anything sufficiently attractive to persuade us to move to another type of tariff, particularly one that requires us to shop around every year or two". The CMA finds this unacceptable and undesirable: these 70 per cent of customers have made the wrong choice.

The CMA goes further. These customers are making such a bad choice that they must be prevented from having a Standard Variable Tariff, or any kind of evergreen tariff. In this respect, the CMA's aim is not to promote competition, it is to *prevent* competition from meeting what it deems to be inappropriate customer preferences.

The CMA puts its own preferences as to how customers should behave over the preferences of customers themselves. It is in effect advocating - and taking steps to bring about - a change of customer lifestyle. It gives priority to one aspect of a competitive market – the constant search for better alternatives – over another aspect – the building of successful and lasting customer relationships. Both aspects are important for customers. Is it the role of the CMA to distort the market in one direction rather than another, to prioritise price over customer loyalty, to promote instability rather than stability?

In so many respects, the CMA's analysis of retail competition bears the hallmarks of Ofgem's Ad Hoc Economics. For example, the refusal to look at actual competitive retail energy markets and the reliance instead on an imagined well-functioning market, the benchmark of a market in competitive equilibrium instead of in a rivalrous discovery process, the blurring of how customers actually act and markets actually operate with how the CMA thinks they ought to act or operate or would like them to act or operate, the notion that effective competition relies on certain sorts of customers, the implicit assumption that most customers make wrong choices, the focus on changing supplier to the exclusion of building up a customer relationship, the failure to acknowledge at this stage that previous regulatory policies found to be anticompetitive could have adversely affected customer engagement and increased supplier profits so that rescinding of these policies could contribute to addressing these issues, the groundless belief that an Ofgem website would increase customer trust in comparison websites, the cavalier proposal that 70 per cent of residential customers should simply be denied the form of tariff that they have explicitly or implicitly chosen, the recommendation of a price control in the belief that it is possible to set the level of a safeguard tariff "just right" so that it won't have disincentive effects, the lack of sensitivity to public choice economics associated with a price control, the lack of acknowledgement that independent economists have argued strongly against price controls and that regulators of successful competitive energy markets around the world have removed them. The list is almost endless. The CMA, like Ofgem, no longer does economic regulation.

16. Where now for the UK?

The CMA's provisional report and possible remedies are out for consultation. To date there have been over 80 responses. A few have been supportive of a price control, but most have been cautious or argued against. The six large suppliers have argued, in addition, against the CMA's characterisation of unengaged customers and the asserted **excess profit levels**. The CMA has decided to extend the deadline for its final report from December 2015 to June 2016 although it plans to publish provisional remedies in January and its final report in April.

Ofgem says, "We strongly agree with the CMA's analysis on weak customer response and the presence of unilateral market power over inactive customers in the domestic retail market." Indeed, it points out how far the CMA's analysis reflects its own earlier submission to the CMA. Ofgem's position on the safeguard tariff is more nuanced, and it wishes to explore with the CMA how any such tariff is tightly targeted and transitional.

If the CMA confirms a regulated transitional safeguard tariff as a remedy, and such a tariff is implemented, what would be the consequences? Initially, the removal of the simple tariffs constraints would enable a greater variety of tariffs, which might encourage some greater customer engagement and switching. However, this is likely to be dominated by the disincentive effects of the regulated tariff. It seems unlikely that customer engagement would be so much higher that Ofgem could declare that weak customer response is no longer an issue. Although there might be pressure from within the industry to remove the regulated tariff, there would be pressure from outside the industry to continue it.

Rather than remove or reimpose the safeguard regulated tariff, Ofgem might opt for another reference to the CMA. The next CMA panel would surely find that the safeguard regulated tariff, like Ofgem's own regulation, had had an Adverse Effect on Competition. Then this next panel would either decide that the present panel's Ad Hoc Economics were inappropriate, or it would follow the same logic and conclude that even more radical restrictions were necessary. These might include:

1. a revival of Ofgem's previous proposal of a uniform standing charge set by Ofgem (the Procrustean Bed);
2. a requirement that tariffs have zero standing charge and comprise only a single unit rate (described by its advocate as the petrol pump approach);
3. an Ofgem-approved arrangement for the collective purchasing of energy following a series of competitive tenders; or,
4. responsibility for providing and/or purchasing energy henceforth to be handed over to local or national governments.

There are obviously strong arguments against such developments. However, the present CMA analysis and remedies point the sector in this direction. Furthermore, the logic of the CMA's present argument would seem to imply that safeguard price controls are appropriate in a number of other sectors where engagement measured by customer switching of suppliers is lower than in energy (in the UK, sectors such as mobile phones, mortgages and current accounts), and/or where trust in the customer's own supplier is reportedly lower (sectors such as retail banking, car insurance and mobile network providers), and/or where the price differentials between comparable products are greater than in energy (as in the mortgage, broadband and payTV markets). In short, if the CMA's present Ad Hoc Economics are taken seriously, the implication is a far-reaching shift in the UK economy towards more restrictive regulation and the wider introduction of price controls.

SECTION II: THE COMPETITIVE RETAIL ENERGY MARKET IN AUSTRALIA

1. Introduction

Many states in Australia – notably Victoria, South Australia and New South Wales (NSW) - have now opened their residential energy markets to retail competition. Regulators there have dealt with misselling issues, and the largest retailers have withdrawn from that sales channel. There has been new entry and an increase in the variety of tariffs offered. Australian regulators have spoken highly of the development of competition and have removed price controls to further such competition. In the light of my critique above of what the UK energy regulator and the CMA are saying and doing with respect to the retail market, I am extremely supportive of what Australian energy regulators are saying and doing.

Nonetheless, occasional concerns are expressed about the competitive energy market in Australia. Some commentators are following UK experience and wondering whether additional regulations should be imposed. There has also been a suggestion to re-impose price controls as per the CMA proposal.

This second section of the paper reviews and comments on three contributions to the debate:

1. Dr Ron Ben-David, chairperson, Essential Services Commission, *If the retail energy market is competitive then is Lara Bingle a Russian cosmonaut?*, presentation to NEM Future Forum, 25 June 2015;
2. CME, *A critique of the Victorian electricity market: A report for the Brotherhood of St Laurence*, June 2015; and,
3. Gerard Brody, CEO Consumer Action Law Centre, "Power price deregulation has failed", *Climate Spectator*, 31 July 2015.

I start with the first publication, weaving in elements of the second and finally look at the third.

2. The criteria for assessing a competitive market

Dr Ben-David's presentation (henceforth RBD) is stimulating, thoughtful, original and provocative. In summary, I appreciate his appraisal of the present evidence on the existence of competition in the Victorian energy sector, although I would interpret it a little more positively. The evidence on profit margins does indeed raise questions, although I am not convinced by the arguments on price shock and tariff structure. Nor do I find convincing the arguments about the special nature of the energy sector. However, I do agree that the appropriate regulatory response is not to leap in to "protect" customers, but to enhance competition, and to ensure that regulators don't inadvertently inhibit the emergence of new and disruptive business models. I now take in turn the main issues and arguments in his presentation.

I agree that competition and effective competition are seldom defined. However, the AEMC's six (later five) broad tests mentioned are very similar to those that Ofgem used in deciding that the market was sufficiently competitive that price controls could be abolished in 2002. So these are familiar criteria to regulators.

RBD is concerned with the interpretation of four of these tests. He asks: if they are met, does it really mean that competition is effective and leading to greater efficiency? Could the same logic not imply that Lara Bingle is a Russian cosmonaut?

The answer to the second question is: No. The difference between the AEMC's six competition tests and the Lara Bingle arms and legs test is that the six tests are an attempt to specify the most significant respects in which a competitive market can be distinguished from a non-competitive one. If a market "passes" all or most of those tests, we have good reason to describe it as competitive; if it doesn't we have reason to believe it is not competitive. In contrast, arms and legs are just one of many attributes that a Russian cosmonaut and other people have; they are of no particular significance in terms of identifying whether a person is a Russian cosmonaut.

Because the cited competition tests attempt to identify the most critical aspects of a competitive market, we should attach significance to a market passing these tests. However, I do agree that there is a valid question about what constitutes "passing". In answering the question, it is helpful to look also at emerging international experience, and also at evolving experience over time.

3. Customer churn rates

To illustrate, RBD notes that the ESC estimated Victoria's 2011-12 customer churn rate at 26 per cent, but then adjusted it down to 17 per cent to net out moves between premises and new dwellings. He asks whether this lower number is demonstrative of less competition, and what number indicates a competitive market.

Whichever value is taken for Victoria, it is still high by international standards. Churn in the UK, previously one of the world's most competitive retail markets, increased from 15 per cent in 2003 to 20 per cent in 2008. Under the impact of Ofgem's regulation it has since dropped back to about 10 per cent.⁴ Many other markets are technically "open" to competition but score lower on most of the AEMC criteria, and churn is often only a few per cent. In general, more competitive markets like Victoria are characterised by higher churn.

RBD says "The only insight that high customer churn rates provides is that customers *can* move between retailers with relative ease if they so choose. While this is a valuable insight in its own right, it cannot be interpreted as telling us anything more substantial about the level or nature of competition in the market. Churn rates tell us nothing about the effect of that churn." (p 11)

I would argue that it does tell us more. It means that retailers have to be more concerned about losing their customers than they otherwise would be. If churn is 20 per cent, on average a retailer will lose two thirds of its customers in five years. CME (p 15) cites AGL Energy as expecting to lose 35 per cent of the new customers it acquired from the acquisition of APG. It is impossible to sustain those kinds of losses without responding, and still survive. The retailer, therefore, has to put much more effort into persuading existing customers not to leave, and persuading new customers to leave other retailers and join it. This means that the retailer has to be much more alive to what customers want, has to find and offer what will attract them to such an extent that they are prepared to take the trouble to leave their current retailer. I come back later to the important question that RBD raises as to whether this is a "good thing". But I do think that churn, and changes in the level of it, tell us a lot about the level and nature of competition in the market.

4. Number of retailers and market shares

RBD notes that although there were about 35 licensed electricity retailers in Victoria in 2013-14, about 96 per cent of the customers were supplied by six truly independent groups. CME notes that many new entrants have gained market share, but then subsequently been acquired by three incumbent retailers. RBD says that "whether the number [of retailers] is 6 or 16 or 3, is not particularly insightful. It is just a small piece of information that tells us nothing about how those providers interact with customers or each other." (p 12)

⁴ The UK figure is unadjusted for moves and new dwellings, and refers to domestic (residential) customers only, not including small businesses. It has been estimated to me that moves and new dwellings might each reduce the UK figure by about one percentage point, but adding the churn of small business customers might increase it by a couple of percentage points. So the comparable net UK figure today would still be below both Victoria figures.

There is a long-standing debate whether the number of players in a market makes a difference to competition. On the one hand, in a market with six retailers there is more choice than in a market with three, and there is yet more with 16 retailers. The chance of retailers offering different levels and types of tariff customer service surely increases with the number of retailers, provided (as is likely) that they are taking independent decisions. Collusion and tacit coordination are less easy the more players there are. Innovation is more likely the more and different players are competing in the market.

On the other hand, small retailers may not be able to compete as effectively in some respects as larger ones. There may be economies of scale in purchasing, marketing or in serving customers. Larger retailers generally offer a greater variety of tariffs than smaller ones.

I agree that information on the number of retailers at any time is only part of the picture. It should be supplemented by information on how the number and size of retailers is changing over time. This gives a valuable indication of whether players are actively competing with each other, gaining and losing market share, or whether they are more inclined to a "live and let live" approach to competition. Information from other markets can also shed light.

Thus, as explained above, in the UK until 2008 the largest six retailers supplied 99 per cent of the residential market, but one of the smaller retailers fought its way up to become the second largest. Since then, relative market shares have not changed much. Setting aside the largest retailer (British Gas Centrica, an incumbent in gas but a new entrant into the electricity market), the next five retailers have about 3 to 5 million electricity customers each, plus about 2 to 3 million gas customers. I believe that the largest three retailers operating in Victoria are not quite of this scale on a national basis. This may suggest that economies of scale have driven their acquisitions in Victoria. On the other hand, there has been significant new entry into both markets, with the new UK players bringing some different ideas (for example, paying interest on prepayment credit balances, and more personal customer service arrangements). CME mentions a new Victoria retailer offering "highly innovative retail products" (p 16).

Is it a problem if new entrants are gobbled up by incumbents once they reach a certain size? It might be if that prevented further new entrants. But there seems no reason why it should, given that there are no meaningful barriers to entry. (CME p 15) On the contrary, if entrants see a prospect of being bought out by incumbents this provides an added incentive to enter. So the number of retailers and their market shares, and the changes over time, are supportive of the existence of competition in Victoria.

5. Product differentiation and customer response

CME (pp 15-16) is concerned that there has not been much progress on product innovation. It instances magazine subscriptions, airline and credit card loyalty program points, monthly cash prize draws and gift cards, discounts for online accounts, dual fuel, direct debit or prompt payment, free power on Saturdays or the electricity retail equivalent of "happy hours", introductory sign-on bonuses. It suggests these might be evidence of good marketing or management of credit risk, but not product innovation.

RBD notes that much of the product differentiation relates to tariff structures and that many customers don't seem interested in the market. He poses the question whether these are the wrong products as far as customers are concerned. (p 13)

My answer would be that energy retailers have been differentiating their product where they can. (The further development and adoption of new technologies and the more widespread use of smart meters can, of course, be expected to offer more and better opportunities for product innovation.) In doing so retailers have asked themselves what customers want. And as they have learned more about customers they have tried to provide it. Whether or not these are "product" innovations, they are innovations that are welcomed by many customers, that in most cases reflect costs better than previous tariffs, and that were never conceived of before the retail market was opened to competition.

Before the advent of competition, retailers were not particularly interested in discovering or providing what customers wanted, or what the costs of different arrangements were. If retailers are not providing the right products for customers now, it is not for want of

trying. But the fact that customers do respond to these various innovations suggest that they are what customers want. In the UK, for example, customers do like discounts, and significant proportions of them are prepared to move to direct debits, pay promptly and deal online in order to gain them.

RBD is concerned that only a low proportion of customers seems to be actively engaged in the market. But measuring engagement is not straightforward. Large retailers in the UK have been particularly critical of the CMA for (as they see it) understating the extent of such engagement.

It is true that if the annual churn is, say, 20 per cent then 80 per cent of customers are not sufficiently concerned to switch retailer. But does that mean that they don't ever switch, or don't switch products while staying with a supplier, or don't keep an eye on what is happening in the market, or don't form a judgement about whether it is worth participating? Suppose they take the view that competing retailers have not yet found something sufficiently interesting to persuade them to move supplier? Does this mean that they are not engaged, or that suppliers are not trying to find such attractive products? Or does it rather suggest that it is a pretty tough task to improve on what the customers are presently getting, without imposing what the customers regard as undue costs and risks? I come back to this later, since it seems to me that RBD, CME and I all have some reluctance to force customers into a change of lifestyle that they would not otherwise choose.

6. Competition or competitive outcomes?

Concluding his reflections on the five or six competition tests, RBD concludes that "the findings from applying each of these tests do not leave us any the wiser about the true nature of competition. These tests reveal signs of competition, not proof of it." (p 18)

I agree that they are signs, not "proof", but they seem to me as convincing signs as one is going to get. If there is any better way to get "proof" then we need to know what it is. Consequently, the AEMC's warning against the unintended consequences of intervening seems apposite: the key question is not whether the market is "sufficiently" competitive but whether there is a reasonable confidence that a particular intervention will make it more competitive rather than less competitive, and will not have unintended adverse consequences.

RBD suggests that "economic regulation focuses on the pursuit of economic efficiency — typically defined in terms of consumer outcomes such as service mix, quality, and price; and upholding competitive (or competitive-like) outcomes wherever possible." (p 6) So competition is a means to an end — greater efficiency in meeting consumer outcomes — rather than an end in itself. This leads him to suggest that we can do better by "focusing on competitive outcomes rather than signs of competition *per se*". (p 24)

I am happy to accept the first two propositions, but the third raises the question whether and how we can identify and appraise "competitive outcomes". Competition is a means of discovering and providing what it is that consumers want. In general we do not have a better means of doing either of those things. I have argued that Ofgem and the CMA in the UK have been led astray when they have thought that they could determine what customers want better than the competitive market could. So the challenge for RBD is to demonstrate how we can do better by "focusing on competitive outcomes". In particular, how do we know what are "competitive outcomes"? He suggests three tests: retail margins, transmission of supply shocks, and persistence of particular (two-part) tariff structures. I take them in reverse order.

7. Persistence of two-part tariff structures

RBD argues (pp 29-33) that two-part tariffs have no place in competitive market outcomes. He suggests their persistence is evidence of a lack of competition, and/or a hangover from previous regulation.

I am not persuaded. It seems more likely that they are not found in markets for most other products because customers in other markets do not have to be registered to particular suppliers in order to buy from them. The costs of maintaining a customer relationship in other markets is zero or negligible. In other markets, retailers do not have to visit their customers each month to record what they have consumed, nor do they have to incur costs associated with gaining and losing customers. Customers cannot simply call in at a particular retailer and buy a few units of energy, then a few units from another retailer the next day. There are substantial costs of changing energy supplier. These costs seem to be higher in energy markets, relative to actual consumption, and retailers are naturally concerned not to be unduly exposed to them.

So, two-part tariffs seem entirely plausible in the retail energy market, and not inconsistent with active competition. They are also found in a few other markets such as communications that are generally considered competitive.

However, in a competitive market, one would also expect the nature of the tariffs offered to reflect not only the costs that suppliers incur but also the preferences of customers. If some customers did not like standing charges, one would expect some retailers to offer the option of a tariff without standing charges, with other elements of the tariff serving to cover the costs of providing it. That is precisely what happened in the UK almost immediately after the market opened. This was to my great relief as electricity regulator since particular groups of customers, notably old age pensioners, had long been demanding such tariffs. First one, then gradually all, retailers offered them, and they proved very popular with these customers. Indeed, I seem to recollect that one retailer transferred all its customers on to tariffs without a standing charge. Typically, such tariffs would then have two unit charges, so they could recoup customer costs over the first few units and then reduce price to customers for subsequent units.

It is regrettable that Ofgem's simple tariff regulations mitigated against the continuation of these tariffs. (They are not prohibited, but retailers are now allowed to have only one unit rate, which means they are expensive for the retailer at low levels of consumption and expensive for the customer – hence not competitive - at high levels of consumption.)

It is surprising to me that such tariffs have not yet appeared in Victoria. But rather than conclude that this indicates a lack of competition, I would be inclined to explore why it is the case. What is different about Victoria, or Australia generally, compared to the UK? Are fixed network charges higher in Victoria, for example, because of the accelerated roll out of smart meters and communications that has not yet occurred in the UK? Are network charges as a whole a greater proportion of the bill in Australia? Or could it be an inadvertent consequence of the required standing offers, which have led to competition focusing on discounts from those offers rather than on different tariff structures? I do not know the answer to these questions, and I would be surprised if the answer were lack of competition, but I do think the issue is worth exploring.

8. Pass-through of price shocks

RBD says that, "In competitive and efficient markets, we would expect that industry-wide input price shocks will be rapidly transmitted by producers through to consumers." (p 27) He observes that certain cost increases have been rapidly transmitted to consumers, but is not convinced that a particular cost reduction, related to the repeal of the carbon pricing regime, has not been. His concern seems to be that the Australian Competition & Consumer Commission (ACCC), mandated to monitor the price reduction, did not pick up certain concerns that St Vincent de Paul identified.

Although this cost change is a particular instance in Australia, it is an example of what has become known in the UK and elsewhere as the "rockets and feathers" phenomenon. When costs increase prices go up like rockets, when costs come down prices float down like feathers. The allegation is that when firms have market power, they respond differentially to cost increases than to cost reductions, whereas if they are in a fully competitive market they don't differentiate in this way.

A few years ago Ofgem investigated this allegation in the UK retail market and found the evidence was ambiguous. More recently it claimed more tangible evidence. The professional economic literature seems to have been inconclusive. The first and most extensive

empirical analysis by Professor Sam Peltzman (University of Chicago) found that about two thirds of markets were characterised by this phenomenon, but it had no obvious relationship to market concentration or market power. A more recent theoretical finding by Dr Robert Ritz (University of Cambridge) is that there is no theoretical reason why rockets and feathers *should* be related to market power.

Ofgem put its evidence to the CMA. The CMA examined it as part of a wide-ranging look at cost pass-through and asymmetry, but seems to have attached no particular significance to it, even though it made a general finding that retailers have and have exercised market power.

It is for others to consider whether the Victoria price shock is worth examining further. However, if a cost reduction has not been as rapidly transmitted to customers as a cost increase, this is not necessarily a sign that the market is not competitive and efficient, and the CMA does not seem to have attached particular importance to such evidence in the UK.

9. Retail margins

RBD (pp 16-17, 25-26) cites an ESC study and other evidence that retail margins have increased in Victoria, and that retail prices are inexplicably high. CME reviews similar evidence and makes its own additional calculations (pp 10-14). It finds that retail charges increased by 2.4 times from 2008 to 2014, following the removal of price control in 2009.

RBD notes that Energy Supply Association of Australia (esaa) refutes the ESC study, claiming that the methodology is faulty and the evidence is unconvincing. In particular, calculations are based on generic industry assumptions rather than on data for individual companies. The esaa has not commented on the CME analysis. It has been suggested to me that questions might be raised about the variety of sources used in the CME calculation, about the assumptions that have to be made given that there is no direct evidence of the prices actually paid by customers, and about the completeness of the wholesale cost assumptions (for example, whether they adequately include the costs of hedging, variations in load profile, network losses and market fees).

The points made by esaa about the ESC study seem reasonable to me, as do the questions about the CME study. Both merit further examination. But I am not familiar with the particular studies in Victoria and do not know where the correct answer lies. I am struck, however, by one similarity with the present situation in the UK, and one difference.

The similarity is that there is a debate between regulators and suppliers in the UK too. The CMA has recently issued its provisional report including a calculation of the extent to which the average prices of the six large energy firms were above the levels that it considered would characterise a well-functioning competitive market. And the six large energy firms have all criticised the CMA's calculations with particular vigour. It remains to be seen how the CMA responds to this. I can only report my own feeling that the CMA's calculations look particularly obscure and tenuous. (Amongst many assumptions, for example, they seem to involve calculating what lower quartile supplier costs would be, deeming that any supplier cost above that is inefficient and an indication of market power, and incorporating that extra cost into the allegation of overcharging.) The critics seem to have some good points to make, as regards both methodology and costs to be included in the calculation. I would be surprised if the CMA does not in some way modify its analysis and conclusions in the light of them.

The difference with the UK situation is the availability of relevant data. In about 2008, Ofgem initiated a requirement on the major players to publish segmented accounts on a consistent basis. These accounts separated their costs and revenues into wholesale and retail sectors, and indeed as between domestic (residential), SME (small and medium enterprises) and I&C (industrial and commercial customers) segments. In contrast, calculations in Victoria, and presumably the rest of Australia, seem to be at a relatively aggregate level, and are vulnerable to the very broad brush assumptions needed to make interesting comparisons.

It may be the case that margins have increased in Victoria. But given the limitations of the data, is this the only interpretation, and does this indicate that the margins are excessive and that there is significant market power? Is it possible to reconcile this interpretation with the other indicators of a competitive market?

If the claims about significantly higher margins, maintained over a period of time, are true, and if profits are excessive, this implies at least two things. First, that somehow incumbent suppliers have managed to increase their margins without competing with each other to bring them down. This has to be reconciled with the evidence that some 26 per cent of customers (or 17 per cent net of house moves and new premises) change supplier each year.

Second, it implies that these suppliers have managed to prevent potential new suppliers from spotting the profits that are being made, or have managed to limit or delay their entry. Again this seems difficult to reconcile with the evidence that there are not significant barriers to entry, and with the actual entry of new suppliers. I am told, also, that two large supermarket chains have expanded their activities over recent years to include home improvement stores, petrol stations, bottle shops and mobile phone plans. If electricity retailing is becoming such a profitable activity, why aren't the supermarkets jumping into this market too?

Of course, it is also possible that the large profits do exist, and that potential entrants have not yet been able to respond, but are in the process of doing so. It thus seems prudent to investigate the profit calculations further and to defer a judgement for a while. If it is true that excessive profits are being made, this has to be weighed in the balance against the other signs of a competitive market. But firmer evidence of the levels of profit and of change over time will be valuable before rushing to judgement and taking regulatory action that might have unintended consequences.

10. Other arguments

The next section of the RBD paper argues that energy is an essential service, that customers are trapped in the market, that this limits competition between retailers, that retailers will "stick with the herd" and not compete, that only relative performance matters, that consumers will therefore become disinterested, that retailers are engaged in a costly "arms race" and that these costs are transferred to customers in a way that is not the case in other markets.

I'm afraid this section strikes me as reminiscent of Ofgem's Ad Hoc Economics. As RBD observes, Ofgem struggled with the question how to deal with a market that didn't deliver the outcomes Ofgem wanted. It intervened in the market, referred the issue to the CMA, and the CMA has now found that its actions reduced rather than improved competition.

11. Regulatory remedies?

I agree with RBD and CME that we need to question whether the market is competitive. Evidence that profits are excessive needs to be taken seriously, albeit needs to be reconciled with other evidence that the market seems to be competitive. CME puts forward an important set of questions where further information and analysis would be desirable. Maybe regulation can provide access to better data here.

If there is evidence of excess profits, the challenge is to find an intervention that makes the market more, not less, competitive. Here, too, I agree with RBD that providing more information, or nudging/compelling customers to engage more, is not necessarily a better outcome given their own preferences. Ofgem's non-discrimination rules and its insistence on simpler tariffs are policies to avoid.

More generally, it is unwise to use customers as a vehicle to drive competition in the market. That can have unintended consequences. For example, if customers are encouraged to change retailer more frequently, that will increase supplier costs (as well as customers' own costs of time), which will need to be recovered in prices. If customers move on quickly, suppliers will find it less attractive to offer

initial discounts to new customers, and/or will introduce cancellation charges, which may reduce switching. The full impacts of regulation are not always possible to identify, and not always welcome to the intervening regulator.

CME canvases the reintroduction of regulated standing tariffs. However, he questions whether it would be futile and notes that it would be difficult to define an appropriate tariff in a world that is changing to include distributed generation. He therefore advises that this remedy should be approached with care. I would go further: regulated tariffs would lead customers to believe that they no longer needed to search for better offers, could facilitate coordinated activities by retailers, and could encourage a move to a wider and more detailed regulation of tariffs, which would undermine competition.

Even the required publication of standing offers without their level being regulated may reduce or distort competition – for example, by channelling competition into percentage reductions on those tariffs and by facilitating coordination. The requirement that standing offers can only be changed every six months increases the risk on suppliers and means that the tariffs will be set higher than otherwise would be the case.

CME considers the regulation of fixed charges. A high level of such charges is an understandable concern for low income and vulnerable customers. But as argued above, this is not evidence of market power. The priority should be to understand why the fixed charges are so high in Victoria, and why retailers are not offering tariff variations with low or zero fixed charges. And before considering the regulation of fixed charges, it would be more appropriate to consider a more limited and focused approach, such as inviting or requiring major suppliers to offer a low fixed charge option.

12. Mr Brody's analysis

Mr Gerard Brody notes a report suggesting that Victorian energy retailer profit margins have increased substantially since 2008. As suggested above in context of the ESC and CME studies, it would seem helpful to get greater clarity on prices and profits, so as to be able to reconcile with other evidence of competition in the market.

Mr Brody also notes a report about large divergences between the most expensive and cheapest tariffs in Victoria. One of his concerns is that discounts from a standing tariff are misleading, another is that the Victorian Government's My Power Planner calculator is useful but difficult to use and not well known. Again as suggested above, there is a question whether requiring suppliers to publish standing charges that can only be changed every six months is conducive to competition. It also seems worth trying to understand why more commercial price comparison and switching sites have not entered the Australian market. Many of those operating in the UK are very well known and easy to use, and are now the major means of customer switching.

Mr Brody then notes the investigation and provisional findings of the CMA, and advocates a similar price cap, "to benefit those who don't or aren't able to shop around". He argues that this would reduce the difference between the most expensive and cheapest tariffs, consumers would not be rolled over onto inflated tariffs when their contracts ended, and discounting would no longer be misleading.

The precise way in which the CMA might design a price cap, if it eventually decides to impose one, is yet to be decided. It is not certain, for example, whether it would be a uniform cap for all suppliers or a set of supplier-specific caps. So it is not certain that, with a price cap, discounting would be any clearer in Victoria.

It is likely that a cap would reduce the difference between the most expensive and cheapest tariffs. However, that would include by eliminating or raising the cheapest tariffs, so those who shopped around would be worse off. As argued earlier, a price cap would generally limit and discourage competition, so that tariffs generally would be higher than they otherwise would be. In this sector, as in the competitive market generally, price controls are not in the long-term interest of customers. So if there is a problem with competition in the retail energy market in Victoria or Australia generally, which is by no means established, price control ought to be the last remedy explored rather than the first. Attention ought rather to be directed to enabling all customers to benefit from the competitive market.

13. Conclusions

RBD and CME seem to be of the view that, over the long term, it is better to make the competitive market work, and let competition rather than the regulator work out whether there are unsustainable and inefficient practices in the market and deal with them. I agree with this. Moreover, as they recognise, smart meters and other technologies such as rooftop solar PV and distributed generation are changing the game. For example, it has been calculated that rooftop solar with the help of subsidy can be competitive with retail electricity, and new leasing models mean that no down-payment is required by the householder. These new technologies will give customers more choice and new options, in an industry whose structure in the future may be quite different from what it has been until now. The ESC is therefore right to revise its licensing structure to help bring about a more flexible, innovative and responsive market. Increasing competition, rather than increasing regulation, is the most effective way to protect the interests of consumers.

Additional Reading:

A selection of Ofgem and CMA publications and critical comments

Ofgem, *Energy Supply Probe - Initial Findings Report, 140/08, 6 October 2008*

Ofgem, *Retail Market Review – Findings and initial proposals, Ref 34/11, March 2011.*

Ofgem, *Decision to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain: Final decision, 26 June 2014*

Ofgem, OFT, CMA, *State of the Market Assessment, 27 March 2014*

CMA, *Energy Market Investigation, Provisional findings report, 7 July 2015*

CMA, *Energy Market Investigation, Notice of possible remedies, 7 July 2015*

Stephen Littlechild, *Protecting customers or suppliers? A response to Ofgem’s consultation on its Retail Market Review – Updated domestic proposals, 21 December 2012*

Stephen Littlechild, *The competition assessment framework for the retail energy sector: some concerns about the proposed interpretation, European Competition Journal, 10 (1), April 2014, 181-202*

Five former energy regulators [Littlechild et al], *Submission to CMA on Summary of Provisional Findings Report and Notice of Possible Remedies, 16 July 2015*

Steve Smith, *The use and abuse of the notion of effective competition: Carroll, Orwell and McCarthy revisited? Zeeman Lecture, RPI Competition Policy Conference, Oxford, 8 September 2015*