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Agenda

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Ofgem's anti-competitive practice

Energy suppliers are currently subject to a licence condition that limits the differences in the tariffs that they can charge to their 'in-area' customers compared with their 'out-of-area' customers. Ofgem, the GB energy regulator, is minded to retain this licence condition, claiming that it has helped customers. However, Stephen Littlechild, Emeritus Professor, University of Birmingham, and Fellow, Judge Business School, University of Cambridge, argues that the condition is anti-competitive and has made things worse rather than better

Three and a half years ago, Ofgem published its Energy Supply Probe, which explored the competitive functioning of the energy supply markets in Great Britain. One concern highlighted by Ofgem was 'a range of differences in the prices of tariffs which could not be justified by cost. This included former electricity incumbents charging a higher price for their home regions ("in-area") compared to their entrant regions ("out-of-area").'[1] In September 2009, Ofgem introduced an Undue Discrimination Prohibition licence condition—Standard Licence Condition 25A (SLC 25A). This was intended to protect less active in-area customers.

SLC 25A had a three-year sunset clause, to allow it to lapse three years after its implementation. However, Ofgem has recently stated in a consultation paper that it is minded to retain the existing Undue Discrimination Prohibition licence condition until July 31st 2014. Ofgem has invited views on this proposal.[2]

I argue in this brief response that Ofgem has not considered the available evidence on the effects of introducing SLC 25A. This evidence suggests that the condition has adversely affected active residential customers without obviously improving the situation of inactive ones. The condition has also contributed to a reduction in 'churn' between suppliers, and to a multiplicity of tariff offerings, both of which Ofgem has found problematic. This suggests that the condition has caused problems rather than solved them. It has restricted and prevented competition between suppliers, at the expense of customers. Continuing it without the promised review is inconsistent with due regulatory process. The condition should be allowed to lapse rather than be renewed.

Has the licence condition actually protected customers?

In its own appraisal, Ofgem reports favourably on the impact of the licence condition:

> We found since the introduction of SLC 25A the average difference between a supplier's in-area standard tariff and out-of-area tariffs reduced from over £30 to around £13 in January 2011, per customer, per year. We therefore consider that the prohibition was successful in removing or successfully lessening the in and out of area price differentials.[3]

But do price differentials that are more equal mean that in-area customers are better protected? Ofgem seems to have assumed that more equal differentials would automatically mean reduced prices to in-area customers. However, economists have argued that, in the particular circumstances of these markets, it was more likely that suppliers would equalise differentials by increasing out-of-area prices.[4] Which turned out to be the case? Ofgem has claimed that the observed equalisation of differentials reflects a lowering of in-area prices.[5] However, others note that 'because of the volatility of the wholesale electricity market it is difficult to know what the counterfactual would have been.'[6]

There is another piece of relevant evidence. Ofgem has reported a steady increase in retail margins over the period since the introduction of the licence condition.[7] This suggests that the alternative interpretation is more plausible. That is, suppliers have raised prices to out-of-area customers rather than reduced them to in-area customers. Suppliers

have gained by the enforced reduction in competition, and customers have lost out.

In other words, the introduction of SLC 25A has made active customers worse off because they no longer have access to more attractive offers. But it has not made inactive customers better off. And there are serious questions as to whether vulnerable customers, in particular, are better or worse off as a result of the measures.[8] Thus, contrary to the claim in the Consultation paper, the licence condition has not, in fact, protected customers, but in many respects has had the opposite effect.

Ofgem's misunderstanding of the nature of competition

Ofgem has been led to its incorrect conclusion for two reasons. First, it assumes that competition is measured by the extent to which price is equal to cost. On that basis, requiring an equal mark-up of price over cost would secure a more competitive outcome than would otherwise exist.

This reflects a misunderstanding of the nature of competition. In a market where some customers of incumbent suppliers are reluctant to switch, it is to be expected that incumbent suppliers will seek to benefit from higher prices where they can. If some customers prefer to stay with their incumbent supplier despite a £30 price difference, competition will respect these preferences.

However, competition between these suppliers will mean that they charge lower prices to invade other suppliers' areas. Differential prices are a sign of competition, not a lack of it. A refusal to cut prices out-of-area, in order to maintain the same margins as in-area, would indicate a lack of competition. Unfortunately, a reduction in competition as a result of prohibiting price differentials is the situation that SLC 25A has begun to bring about.

Second, Ofgem assumed (or gambled?) that prohibiting price differentials would have a beneficial impact on customers because suppliers would henceforth treat in-area customers as if they were out-of-area. In the event, this assumption/gamble has not paid off: suppliers seem to have found it more profitable to treat out-of-area customers as if they were in-area. Instead of making competition more effective for inactive customers, the licence condition has made competition less effective for active customers.

Other effects on competition

The licence condition has also had another adverse effect on competition. By reducing the average available price differential by over a half, it has reduced the potential benefits to customers from shopping around and changing supplier. This is reflected in the reduced churn that Ofgem notes with concern elsewhere.[9] To be sure, other factors may have contributed to the reduction in churn, including Ofgem's crackdown on selling techniques and the decisions of several suppliers to discontinue doorstep selling. But since the prospective gain from shopping around is an important determinant of churn, SLC 25A will have been an important factor in discouraging customers from being active.

Suppliers have evidently sought alternative ways of competing, by introducing other kinds of price reductions. Ofgem reports that 'since the Probe there has been a marked increase in the number of tariffs available…Since 2008 the total number of available tariffs (online and offline) has increased by over 70%.'[10] But in the same report it expresses concern that the resulting multiplicity of tariffs makes it difficult for customers to decide whether it is worth switching supplier.

These two developments in the market—the reduction in churn and the multiplicity of tariffs—have led Ofgem to suggest an even more serious intervention in the market. It proposes to prohibit suppliers from offering more than one standard tariff per payment method, and to impose a uniform standing charge on all suppliers, to be set by Ofgem. Yet it now transpires that the two concerns that have contributed to this latest proposed intervention have been the unintended consequences of Ofgem's own earlier misplaced intervention in the market.

More recently, the licence condition seems to present an obstacle to an interesting and potentially helpful development in the competitive market that could provide further protection for vulnerable customers. The organisation *Which?* has proposed the 'Big Switch', whereby it will negotiate terms with a supplier on behalf of all those customers who sign up. As at April 2012, the *Which?* website indicates that over 300,000 customers have expressed interest. Yet one major supplier, SSE, has declined to participate, partly on the grounds that 'it appears to risk breaking well-established Supply Licence conditions in relation to "cost reflective" and non-discrimination obligations'.[11]

Due regulatory process

In introducing the Undue Discrimination Prohibition standard licence condition, and in subsequently monitoring the retail market, Ofgem said explicitly and repeatedly that it is 'also committed to a thorough review of the impact of the measures introduced as a result of the Probe, before SLC 25A terminates at the end of July 2012'.[12]

Ofgem now proposes to abandon this commitment and instead to review the extent to which SLC 25A is necessary 'after any relevant RMR [Retail Market Review] proposals have been properly implemented (assuming, following the consultation process, Ofgem ultimately decided to implement relevant proposals)'.[13]

Re-imposing the licence condition without the promised review is problematic for four reasons. First, breaking a regulatory commitment increases regulatory uncertainty, which in turn can be expected to increase the cost of capital and discourage new entry, both of which will lead to higher prices to customers. It will also reduce the credibility of a sunset clause in future.

Second, as explained above, the empirical evidence now available suggests that the outcome of SLC 25A has been the opposite of what Ofgem intended and expected. Arguments put to Ofgem at the time predicted that the licence condition would have these harmful effects.[14] These predictions have come true. It would be unreasonable not to take account of this. At the very least it would be unreasonable not to review the evidence systematically before re-imposing the licence condition.

Third, the responses to the RMR proposals have included some substantial objections. I have set out elsewhere my own serious concerns about the proposed new intervention in the market.[15] Many other responses to that consultation echo these concerns.[16] It must surely be questionable whether the RMR proposals will be implemented in anything like the form that Ofgem originally envisaged, and if so when.

Fourth, in the light of the evidence now available, Ofgem's sequencing is surely getting things back to front. To the extent that SLC 25A helped to cause the problems that led to the RMR proposals, the obvious remedy is not to implement these proposals and then wait to see if SLC 25A is still necessary, but rather to abolish SLC 25A and then wait to see if the RMR proposals are still necessary.

In the meantime, vulnerable customers *are* well protected by competition, despite Ofgem's protestations. The majority of customers that have not changed supplier say they are happy with their supplier, and competition does, in fact, protect them.[17]

Some concluding thoughts

The Undue Discrimination Prohibition SLC 25A was intended to protect customers, but in practice it has had the opposite effect. It has reduced the value of the offers available to active customers without providing obvious benefit to inactive customers. It has contributed to higher retail margins for suppliers rather than lower prices to customers. It has made switching less attractive and thereby reduced churn and the associated competitive pressure on suppliers. It has also encouraged suppliers to find other ways of competing, thereby increasing the multiplicity of offers that Ofgem claims to be problematic. And re-imposing it might now present an obstacle to the development of collective negotiation on behalf of vulnerable and other customers. The licence condition has thus restricted and distorted competition. It has been anti-competitive rather than pro-competitive. And it has been against the interests of customers.

Ofgem rightly committed itself to a thorough review of SLC 25A and related measures before that condition terminated in July 2012. It has now abandoned that commitment. This is unhelpful regulatory practice.

In the absence of such a review, the available evidence indicates that SLC 25A has been harmful rather than helpful. For the sake of customers and competition, it should be allowed to fade away with the sunset, as originally promised.

Stephen Littlechild

Postscript

Ofgem's February consultation on SLC 25A closed on April 10th. Just over a couple of weeks later, on April 27th, Ofgem announced its decision to proceed with a statutory consultation to reinsert the condition (which was due to lapse at the end of July 2012), on the basis that 'we do not consider that at this stage we been provided with sufficient evidence and reasons to alter our views expressed in the February consultation'.[18] This is surprising. Ofgem has long admitted that the condition has not delivered the benefits it expected.[19] But to summarise the concerns put to the February consultation in the phrase 'it was not clear that the condition had delivered benefits to consumers' (p. 2) hardly does justice to the evidence put to Ofgem that the condition has been actively harmful.

As argued above, the evidence suggests that SLC 25A has prevented better offers to active customers without better protecting inactive customers; has restricted competition between suppliers and led to higher retail profit margins; and has reduced the extent of customer switching and led to a multiplicity of tariff offerings, both of which Ofgem finds problematic. Indeed, it now appears that the problems that Ofgem's Retail Market Review proposals are intended to address have largely been caused by SLC 25A. In addition, SLC 25A has been cited by one major supplier (SSE) as a reason for not participating in the *Which?* collective switching exercise, and one of the smaller suppliers says that the condition prevents suppliers from tailoring tariffs to suit customers.[20]

One would therefore have expected Ofgem either to explain why it did not accept the evidence on the existence of these detriments of SLC 25A, or to explain why the detriments are outweighed by the benefit of insisting that all prices be in the same relationship to cost (even though no customers may have gained from this and many have clearly lost). But Ofgem has done neither. It could scarcely have been expected to examine and evaluate this evidence thoroughly in just two weeks. This must raise a question as to whether the proposed policy has been properly considered.

Stephen Littlechild

[1] Ofgem (2012), 'Consultation on the Undue Discrimination Prohibition Standard Licence Condition', Ref 23/11, February 24th, p. 1.
[2] Ibid., p. 3.
[3] Ibid., p. 2.
[4] See, for example, Hviid, M. and Waddams Price, C. (2010), 'Non-discrimination Clauses in the Retail Energy Sector', CCP Working Paper 10–18, University of East Anglia, November, forthcoming in *The Economic Journal*, and literature reviewed therein.
[5] Ofgem (2010), 'Update on Probe Monitoring', July 1st, p. 14, para 2.22.
[6] Hviid and Waddams Price (2010), op. cit., p. 11.
[7] Ofgem (2012), 'Electricity and Gas Supply Market Indicators', updated April 4th.
[8] See Hviid and Waddams Price (2010), op. cit., section 4.
[9] 'We are concerned that the proportion of passive customers is growing. Since 2006, the proportion of consumers switching in any one year has been falling steadily. During 2010, 15 per cent of consumers report switching their gas supplier and 17 per cent report switching their electricity supplier. This compares to 19 and 22 per cent respectively in 2006.' Ofgem (2011), 'The Retail Market Review – Findings and Initial Proposals', March 21st, p. 30, para 2.50.
[10] Ibid., pp. 21–2.
[11] Phillips-Davies, A. (2012), 'Letter to Which? outlining SSE's position on "The Big Switch"', March 12th.
[12] Ofgem (2010), 'Update on Probe Monitoring', July 1st, p. 23, para 4.4.
[13] Ofgem (2012), 'Consultation on the Undue Discrimination Prohibition Standard Licence Condition', Ref 23/11, February 24th, p. 3.
[14] As noted in Yarrow, G. (2009), 'Addressing Undue Discrimination: Final Proposals', response to Ofgem's final consultation, May 13th.
[15] Littlechild, S. (2012), 'Ofgem's Procrustean Bed', response to Ofgem's consultation, January 23rd. A shorter and slightly revised version is available at Littlechild, S. (2012), 'Ofgem's Procrustean Bed', *Agenda*, February.
[16] See Oxera (2012), 'Economic Appraisal of Ofgem's Domestic Tariff Proposals: an Appropriate Intervention to Increase Consumer Engagement?', prepared for ScottishPower, March.
[17] For example, 'Ofgem's charts suggest that competition generally forces suppliers to set their prices to sticky customers within 10–15% of the very lowest price in the market—a price that is sometimes alleged to be actually below cost.' See Littlechild, S. (2012), 'Ofgem's Procrustean Bed', *Agenda*, February, p. 2.
[18] Ofgem (2012), 'Proposed Reinsertion of SLC 25A for the Gas and Electricity Domestic Supply Licences until 31 July 2014', letter to holders of gas and electricity supply licences, DECC, Consumer Focus, consumers and their representatives and other interested parties, Ref 61/12, April 27th, p. 2.
[19] 'the market has not materially changed since the introduction of the Probe remedies in 2009' (ibid., p. 2), and succeeding paragraph.
[20] Evidence to the above consultation by Good Energy, April 2nd 2012.