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Dear Maureen

Response to Ofgem on effective competition

We write as former GB energy regulators to respond to Ofgem's Discussion Paper[1] which seeks views on its proposed framework for assessing whether conditions are in place for effective competition in the domestic energy retail market. This is for the purpose of recommending to the Secretary of State whether the cap on default and standard variable tariffs should remain in place, as required under the Domestic Gas and Electricity (Tariff Cap) Act 2018.

Brief summary of our response

The Tariff Cap Act requires Ofgem to report on whether competition would be effective in the absence of a tariff cap, not to design a new concept called "effective competition" that embodies socially desirable outcomes.

It would be helpful for Ofgem to identify in what respects it considers that competition has not been effective. We are not convinced by the reasons suggested in this Discussion Paper.

Competition could be made more effective by removing two present distortions in the regulatory framework (as well as by removing the tariff cap). But progress of the smart metering roll-out does not seem particularly relevant.

Effective competition will not necessarily lead to a socially desirable outcome. It is for Government to specify whether and how certain customers should get additional protection and at whose expense.

The Act distinguishes between Ofgem's view as to whether competition is effective and Ofgem's recommendation whether to extend or remove the tariff cap. The Discussion Paper considers only the first. Ofgem should, in addition, examine the wider impacts of the cap, the pros and cons of extending it, and the possibility of replacing it by other measures.

[1] Ofgem, *Developing a framework for assessing whether conditions are in place for effective competition in domestic supply contracts*, Discussion Paper, 29 May 2019

1. The definition of effective competition

The Discussion Paper (henceforth DP) says that "The Tariff Cap Act does not define what is meant by effective competition, and there is no generally accepted definition in relevant policy frameworks or academic publications." (para 3.1) It claims that "In economic theory the concept of effective competition can largely be traced back to the theory of "workable competition",…" (para 3.6) and that "An overarching theme in the literature is the importance of developing a practicable set of conditions for "directing" competition to achieve socially desirable outcomes." (para 3.7). It says that "In the context of this review, we consider competition to be effective if it involves rigorous rivalry between firms to win and to retain customers, and it results in good outcomes for most consumers in terms of what matters to them (e.g. price and quality of service)."

The DP thus seems to want to define a new kind of competition called "effective competition" that will embody socially desirable or good outcomes. We have three concerns about this.

First, the claim that "An overarching theme in the literature is the importance of developing a practicable set of conditions for "directing" competition to achieve socially desirable outcomes" is not substantiated. The source given for this claim is a paper by Sosnick[2]. However, that paper makes no suggestion that the aim of the workable competition literature is to direct competition to achieve socially desirable outcomes.[3]

Second, the definition makes explicit reference to "rigorous" rivalry and "good" outcomes for "most" consumers, without any definition or explanation of these highly subjective qualifying terms. Nor is there any indication whether, in the DP's view, there is or was effective competition in the GB domestic energy market, and if not why not. This will surely increase uncertainty and invite political and other pressures.

Third, the Tariff Cap Act does not support the notion of defining a new kind of competition or introducing such subjective qualifications. It says only that "7(1) The Authority must carry out a review into whether conditions are in place for effective competition for domestic supply contracts." A natural interpretation is that the Act is asking the Authority (for simplicity this response henceforth uses the term Ofgem) to answer the simple question: would competition be effective if the tariff cap were removed? The Act does not envisage or authorise a different kind of competition called "effective competition" that delivers socially desirable or good outcomes.

2. Was competition effective before the tariff caps?

Surely a natural place to start is to ask whether competition was effective before the tariff caps were put in place? If not, in what respects was it not effective? As noted, the DP does not explicitly pose and

[2] Sosnick, S,H. (1958), "A critique of Concepts of Workable Competition", *The Quarterly Journal of Economics*, 72(3), pp. 380-423.

[3] Sosnick says that "The theory of workable competition is best understood as an attempt to indicate what practically attainable states of affairs are socially desirable in individual capitalistic markets", which (whatever it may mean) is a different proposition.

answer such questions. However, the DP introductory Context does give some indication of its thinking. It says

> "In recent years, competition in the domestic retail energy market has not worked as well as it should for all consumers. Consumers who were active and shopped around usually found a good deal, but less active consumers tended to be on more expensive default tariffs and were paying much more to meet their energy needs. This "two-tier" market was resulting in poor outcomes for many consumers; and these less-active consumers were on average less well-off, less well-educated and more likely to be in vulnerable circumstances."

The Final Report of the CMA Energy Market Investigation (henceforth EMI Final Report) in 2016 found that certain Ofgem policies had an adverse effect on competition in the past, and recommended they be discontinued. Certain features of the present regulatory framework continue to distort competition. Setting these aside for the moment, we agree that active consumers usually found a good deal. But we do not accept that, in recent years, competition in the domestic retail energy market has not worked as well as it should for all consumers, or that less active consumers got a bad deal, or that there was a two-tier market, or that this resulted in poor outcomes for many consumers.

The DP also says "3.19 … A well-functioning competitive process in the energy market is also characterised by efficient energy providers being able to finance their operations and make a reasonable profit." The DP does not comment further on the efficiency and profits of the energy providers, but the EMI Final Report was critical of these. In our view the DP's statement is over-simplified and threatens to impose an unduly severe prerequisite for effective competition.

To explain our views on competition, we take first the question whether retail competition worked well for customers in aggregate, and the issues concerning profits and efficiency, then consider the claims that there is a "two-tier" market and that competition worked well for some customers but not for others. We then indicate the effectiveness of competition taking place over time.

3. The overall effectiveness of retail competition

The DP Context begins by saying

> "For the energy market to deliver good outcomes for domestic consumers, competition between energy suppliers must work effectively. Consumers benefit from effective competition through the price they pay for energy, innovative new products and high quality of service."

Taking these three aspects in reverse order, the notion that a competitive market delivers only one level of quality of service is incorrect. Competitive markets offer a range of qualities of service at a range of prices. There are of course many different ways to measure quality of service. To take just one measure, Ofgem's figures[4] show that customer complaints received by Large suppliers in early 2019 were around 2 per thousand customer accounts, having reduced from 3 ½ per thousand in early 2014. Comparable figures for Medium and Small suppliers were around 1 ½ per thousand, having increased from around 1

[4] Ofgem, Energy supplier comparison data, compare supplier performance on complaints, as of 30 June 2019.

per thousand. This suggests that Small and Medium suppliers have not found it possible to sustain their earlier low complaints ratio as they have grown larger. Nonetheless, competition (and perhaps regulatory pressure too) seems to have forced incumbents to find ways to reduce complaints.

As is often pointed out, there is limited scope for innovation insofar as electricity and gas are homogeneous products. However, there has been increasing innovation by suppliers over the years, particularly in payment methods and associated services. Some examples are indicated later.

The main public concern has been about the price of energy. Over the three decades since energy privatisation, energy prices have increasingly reflected the total costs of supply. Once the retail market opened to competition, prices initially declined, but over the last fifteen years or so they have tended to increase rather than decrease. Does this indicate that retail competition has not been effective? No, on the contrary, the final price increases have primarily reflected increases in the underlying costs of supply (wholesale, network, government social and environmental costs, metering costs etc). Ofgem's consolidated segmental accounts show that, over the last half dozen years or so, the average aggregate supply margin of the six Large suppliers has remained roughly constant at about 4%.

Thus, the competitive retail market has discharged its main function of conveying energy to customers at the cost of producing and distributing it, with a stable average margin for the Large suppliers.

4. Are profits excessive or are suppliers inefficient?

Can it be argued that 4% was an excessive margin? It is a higher average supply margin than the 1.5% that the CMA considered appropriate. However, the CMA's benchmark was its guess at what a hypothetical company would earn at an efficient scale and in a steady state. Stability was an unrealistic assumption given the previous and ongoing changes in the market and their associated risks. The CMA's approach was also inconsistent with the CMA's own Guidelines that said it would not use perfect competition as its benchmark. It is not clear that an average 4% margin is higher than competing suppliers routinely earn in other actual competitive retail energy markets. (The UK is widely held to be the most competitive retail energy market in Europe, perhaps in the world.) And the fact that two of the six Large suppliers frequently made losses over this period does not suggest that large incumbent suppliers are able to exploit any market power.

Can it be argued that the retail costs of the six Large retail energy suppliers are unduly high because they are inefficient? The EMI Final Report suggested this. Ofgem's consolidated accounts show that there are differences in efficiency between the six Large energy suppliers. However, comparable data are not published for Medium and Small suppliers. The CMA's assumptions were based on a comparison with a hypothetical efficient supplier, using some data from two Medium suppliers an order of magnitude smaller than the Large suppliers, and these Medium suppliers were not subject to all the social and environmental obligations of the Large suppliers. There was no allowance for different customer mixes, even though new entrants have tended to focus on and attract low cost-to-serve customers (e.g. paying by direct debit) leaving incumbents with a higher proportion of higher cost-to-serve customers (e.g. paying by cash with higher collection costs).

We see competition as a rivalrous discovery process taking place over time (an approach acknowledged in the CMA Guidelines and at DP para 3.8). In the absence of retail competition, it would not have been possible to discover whether other suppliers could operate more efficiently than the incumbents. That rivalrous discovery process is still in operation. Many apparently lower-cost suppliers have entered the market, but some have already proved unsuccessful: they had underestimated the costs and risks involved. Other suppliers are surviving but their precise costs and durability are uncertain; they have been willing to operate at a loss over several years. And, as noted, the Small and Medium suppliers do not have the same relatively costly customer mixes as the Large ones.

In sum, it has not been established that profits have been excessive or that the Large suppliers are less efficient at serving high cost-to-serve customers than other suppliers would have been.

5. Further examination of cost and efficiency

The DP says "3.19 … A well-functioning competitive process in the energy market is also characterised by efficient energy providers being able to finance their operations and make a reasonable profit."

A reasonable profit presumably means just covering the cost of capital. The claim here that, in a well-functioning competitive market, "efficient" energy providers would make a reasonable profit seems to imply that all other providers, assumed less efficient, would not make a reasonable profit, would not cover their cost of capital, and in that sense make losses.

This would be an untenable proposition. It would impose an unreasonable burden on suppliers, undermine the market and erect an insuperable and unrealistic barrier to the removal of the default tariff cap.

In real competitive markets, supplier efficiencies differ, often considerably. The typical supply curve in economics textbooks is upward-sloping. At the competitive market price, the marginal supplier breaks even – that is, earns a reasonable profit that just covers the cost of capital. Less efficient suppliers make losses. More efficient suppliers make higher (intra-marginal) profits.

The textbook diagrams typically illustrate a hypothetical state of equilibrium at a point in time. In reality, markets exhibit a range of prices and a range of suppliers' costs. Over time, the more efficient suppliers cut prices, attract customers and grow. The less efficient suppliers make lower profits or incur losses and lose customers. That is what was happening in the market before the tariff caps were imposed and slowed down this process (or in the case of the PPM tariff may have brought it almost to a halt).

The relevant legislation does not require that Ofgem should try to ensure that prices are equal to the cost of the most efficient supplier. For example, the Electricity Act 1989, as amended, provides that "3A(2) … the Secretary of State or the Authority shall have regard to … (b) the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed [on them]". It is difficult to see how forcing a significant proportion of suppliers to make losses is consistent with that.

To summarise, the idea that price is or should be equal to "efficient cost", and that only "efficient" suppliers should make a reasonable profit to cover their cost of capital, is not consistent with competition in the real world or with the simplest economic analysis or with present legislation.

6. Is there a "two-tier" market?

The suggestion that there is a "two-tier" market in the retail energy sector is misleading. There is a wide range of prices in the market, not just two tiers. Moreover, these are not two or more different prices for the same product, because there are many different products or product variants. Also, prices may vary because different suppliers may be forced to incur different costs to provide the same product. Here are some examples.

- Some prices are fixed for a defined period, others are variable. A tariff for 18 months including two summers is understandably cheaper than a tariff for one year, which in turn is cheaper than a tariff for 18 months including two winters.
- Some tariffs are hedged against wholesale cost increases, some are not and hence are more uncertain. Some tariffs involve upfront advance payments, thereby increasing cost and risk to customers.
- Tariffs vary in the extent to which they provide green energy and the way in which they do it.
- Some products are available for all payment methods, usually at different prices, others are limited to (e.g.) direct debit. Some products offer initial discounts.
- Some suppliers offer personal telephone contact to resolve questions and problems, others rely on chatrooms. Some products are paperless, with communication online and extra charges for paper bills.
- Some products include sale or promotion of other products (e.g. boiler servicing, home insurance energy saving technologies).
- Some suppliers have very good customer service ratings, others do not. These relative ratings change over time.
- Large and Medium suppliers are required to provide a wide range of social and environmental obligations, smaller suppliers are not so required. Thus, some suppliers are subsidised by other suppliers, and hence their prices are effectively cross-subsidised by customers of other suppliers on other products, as discussed further below.
- Some suppliers are established and well-funded, others are not. Some are financed by local authorities and (so far at least) are in effect subsidised by local ratepayers. Some suppliers are loss-making as a deliberate strategy to gain market share. Some suppliers have met all their credit obligations and survived over many years, others have not. Some 15 suppliers have gone out of business since early 2018.

Of course, active customers can and do explore the market and discover lower prices than the typical Standard Variable Tariffs of the Large and Medium suppliers. But as just explained, these lower prices sometimes reflect products with less familiar and less attractive characteristics that might be less convenient for other customers. In particular, lower prices are often offered by less well-known suppliers that have not established a reputation in the market.

Competition is the process by which customers come to explore these different options and decide which they prefer. Over time, higher priced products that customers deem similar to other lower priced products will gradually be driven out of the market. But this of course is a continuing process. Not only prices but also the options available constantly change as new product variants and new suppliers enter the market.

Consequently, a competitive market is characterised by a multi-tier market, not by a "two-tier" market, nor by a single tier market comprising a single uniform product offered at a uniform price. Such a concept is a hypothetical construct, not a characteristic of real or effective competition.

It would therefore misunderstand the nature of competition to suggest that ineffective competition has led to a "two-tier" market now, and that effective competition would involve the removal or reduction of the alleged price difference between these two alleged tiers.

7. Different types of consumers

The DP says that, in evaluating outcomes for consumers, "4.15 … We will also consider the extent of price differentials between the tariffs that engaged and less active consumers face;". It says that "3.21 … We will assess the potential extent of dispersion of prices in a competitive market, including to judge whether consumers who are less active in the market would face excessive prices."

Quite how Ofgem will do this remains to be seen. There is no obvious economic basis for such a judgement. [5]

As just noted, the less expensive tariffs are not necessarily for the same product as the more expensive tariffs. As regards the prices faced by more or less active customers, it is surely not surprising that "Consumers who were active and shopped around usually found a good deal, but less active consumers tended to be on more expensive default tariffs…." If more active consumers find less expensive tariffs, it follows that less active consumers will remain on more expensive tariffs. However, it does not follow that the more expensive tariffs represent "poor outcomes" for such consumers. For example, these consumers may consider that the potential saving is not worth the hassle of searching or the risk of something going wrong or the possibility of poor service from a new and unknown supplier.

The DP observes that "these less-active consumers were on average less well-off, less well-educated and more likely to be in vulnerable circumstances". This average masks the fact that many less well-off, less well-educated and more vulnerable customers were in fact active, and many better-off, better-educated and not vulnerable customers were not active.

But is it surprising that, on average, the more active customers in exploring unknown new suppliers and product variants are better off, better-educated and less vulnerable customers? Are these not - again on

[5] See also, "… we believe there is no economic logic that can be used to determine what is a 'reasonable' price differential apart from that produced by the market process. Any set price differential would be a value judgement and/or entirely political decision." D Deller et al, Consultation Response from the Centre for Competition Policy, University of East Anglia, to the BEIS Committee Pre-legislative scrutiny of the draft Tariff Cap Bill, 1 December 2017, p 15.

average - the types of customers that are better able to understand what is happening, what is available, what are the implications, and better able to bear the risks of something going wrong – not least the very real possibility of the supplier going out of business?

In the early stages of a competitive market, the more active customers are, in effect, volunteers to become guinea pigs. If their judgements prove right, their reward for the time spent exploring the market and taking these risks is typically a significantly lower tariff and a product variant better suited to their lifestyle. A significant price differential has an important economic role: to alert hitherto uninterested customers to the possibility of something better. Or course, if their judgements prove wrong, these active customers may suffer disappointments and poor service. In either case, these early active customers pave the way for other customers that are (again on average) less able, less assured, less knowledgeable and less affluent to follow in their footsteps (or in some cases, to learn not to).

Thus, those customers who do not switch supplier are nonetheless also benefitting from competition, even though at any point in time they may pay more than those who are actively seeking better deals. They benefit, first, because competition in general is forcing prices to reflect the ever-changing level of costs in the market, rather than allowing suppliers to charge whatever they want. They benefit, second, because the competitive process enables rival suppliers to try out new ideas, and it enables more active and more intrepid customers to test these ideas. Less active customers benefit from the lessons learned by more active customers and by the suppliers that survive this testing process. Over time, the less active customers come to be served by suppliers offering products that better meet their needs, including as to price.

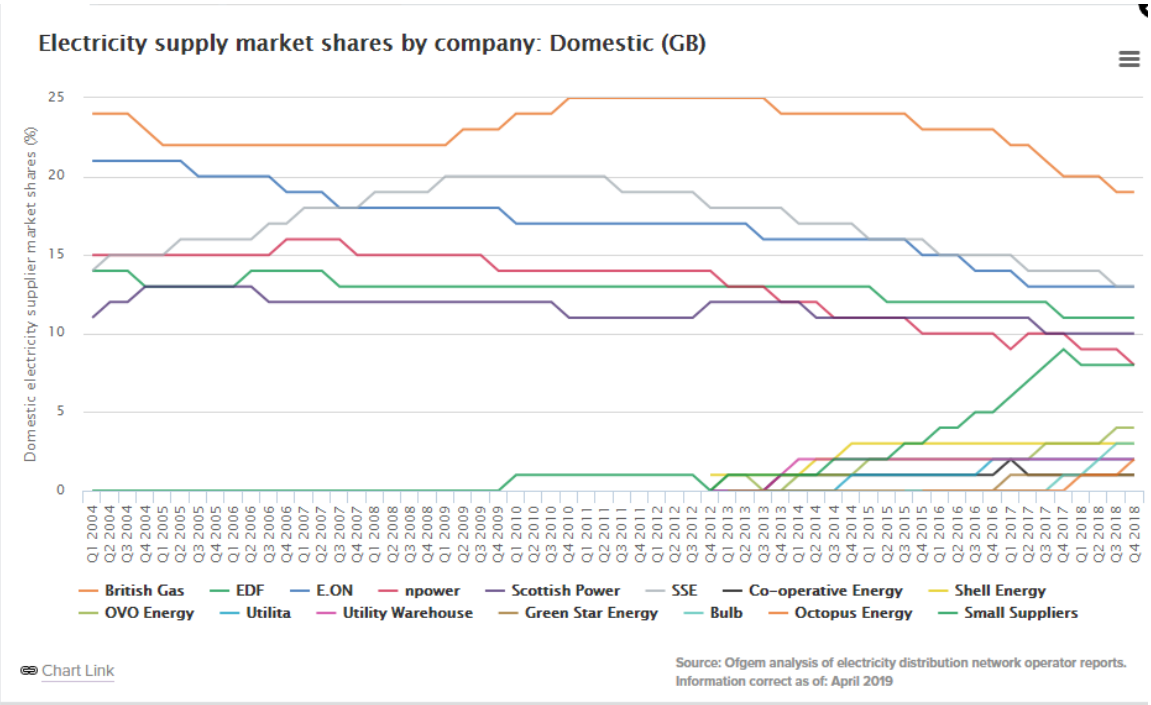
8. Is competition effective in displacing older incumbent suppliers?

Is there evidence that competition is effective as a process over time? Not only in the sense that new suppliers are entering the market and offering lower prices and different product variants. But also in that this is what customers want, and therefore newer suppliers are gradually displacing older incumbent suppliers?

Since about 2012, there has been significant new entry. The total number of active gas and/or electricity suppliers was static at about a dozen from 2004 to 2011. By December 2015, when the EMI Final Report was being prepared, it had grown to 40. It reached 70 by June 2018 before declining to 62 in December 2018 as a number of smaller suppliers were hit by unexpected wholesale price increases.

Market share data suggests that customers are responding to the available price differentials. Ofgem's graph below shows that, until about 2012, changes in market share in the electricity sector reflected mainly rivalry between the six Large incumbent suppliers.

In the six years since then the entrants in aggregate have grown to 26% of the domestic electricity market. This is precisely double the 13% level that the CMA was able to observe in the market three years ago. (e.g. para 8.154 of EMI Final Report) The six Large suppliers have been correspondingly reduced from 99% of the market to 74%.



This chart shows the domestic electricity market shares for each of the six large suppliers, medium and small suppliers.

9. Is competition happening fast enough?

Even if new suppliers are entering the market and displacing older incumbent suppliers, could it be argued that competition is not effective because this is not happening fast enough? We suggest here three main reasons why this seems unpersuasive.

First, the six Large suppliers have not lost more ground precisely because they have competed vigorously and effectively. These former incumbent suppliers evolved out of companies designed to provide a nationalised industry service, which they did for over four decades. It could not be expected to be easy or speedy to reduce their costs of a business model that was no longer fit for purpose, and to incur other costs to cope with a different and rapidly changing competitive energy market. These suppliers had to compete against new entrants with more modern and flexible business models and cost structures designed expressly for purpose.

In the event, the Large suppliers have fought back strongly against lower prices offered by new competitors, offering lower prices on their own fixed products to help stem the flow of lost customers and to attract new ones. So far, this strategy has enabled them to reduce but not prevent the inroad of competitors.

It might be argued that the Large suppliers have managed to survive and compete for active customers only by charging higher standard variable tariffs to their less active customers. But in any competitive market, companies charge different mark-ups on different products, depending on the strength of

demand, in order to cover all their costs.[6] Price differentiation here is a sign of active competition, not of ineffective competition. [7]

Second, the six Large suppliers may have retained some customers because these customers are more costly to serve and therefore less attractive to other suppliers. If, for example, on average, the customers that are less active have lower incomes and have more difficulty paying their bills, then this will increase the costs of revenue collection. Not surprisingly, most new suppliers (excluding those with an explicit social purpose) are less interested in attracting such customers. For example, some suppliers offering low prices focus on direct debit and do not provide PPM or cash products. Other suppliers limit themselves to online products and services that are cheaper to provide but may not be feasible for the customers in question.

The EMI Final Report did not examine these cost-to-serve issues in any depth. In contrast, the competitive market process explores and gradually reveals whether there are such differences in cost to serve, and how ways of addressing that more efficiently can be devised. If systematic differences in prices are emerging, this may be an indication of systematic differences in costs rather than an indication that competition is not effective.

A third reason why the growth of new entrants has not been faster is that about two thirds of customers are not yet convinced that the new entrants offer a sufficiently cheaper or better product to warrant their changing supplier. Many of these other products appear to be lower in price, but how real are the savings, how long will they last, how reliable is the new supplier, will there be downsides in terms of a less attractive product or service, and so on? Moreover, given the hassle involved in choosing and moving to a new supplier, is it worth the effort and risk?

The EMI Final Report and some commentators may think these customers should have switched already, but that is not the view of these customers themselves. The new suppliers have done well to enter the market and convince a quarter of the customers of the merits of their products, but they have not yet convinced the remaining three quarters. Consequently, an important part of the competitive market process is for suppliers to devise more and better ways of alerting hitherto suspicious customers to the advantages of changing supplier and alleviating their concerns. The more responsive customers have heard the message, now the challenge for the new suppliers is to interest the more reluctant and suspicious customers.

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[6] C.f. “Price differentials are an inherent part of almost all real-world markets …”, C Waddams Price, “Back to the Future? Regulating Residential Energy Markets”, *International Journal of the Economics of Business*, 25:1, 147-155, at p 154.

[7] “Moreover, the process of competition, even when considered effective, may generate outcomes that are unpopular with the public and do not meet with the expectations or desires of politicians or policymakers. For example, it is well understood that price discrimination can emerge even in highly competitive markets. Indeed, this can be an efficient form of pricing, as it can widen market access while allowing firms to cover their fixed costs; “yield management” ticket pricing by airlines is good example. Hence, we strongly caution against “effective competition” being viewed as necessarily involving all customers being charged the same low prices. It would be wrong to conclude from the presence of price discrimination that there is something automatically wrong with the functioning of the competitive process.” D Deller et al (2017) p 3.

All this is to suggest that retail competition is not moving unduly slowly or is otherwise ineffective. The average annual switching rate has been steadily increasing and is now double the level it was around 2012. It recently reached 20%, an all-time high. External switching rates are higher in energy than in telecommunications and other products.[8] Rretail energy switching rates are higher in the UK than in almost all retail energy markets overseas. In addition, internal switching of tariffs without changing supplier has averaged about 5% *per month*.

The CMA and Ofgem have been seeking to interest a greater proportion of customers in engaging in the market. Whether this would bring a significant further expansion in switching rates, or a faster reduction in market shares of the Large suppliers, or a significant diminution in the extent of price dispersion in the market, is a matter of conjecture. The argument in this response is that competition is already effective. The market process is working over time. The focus of Ofgem's review therefore needs to be elsewhere: on removing remaining regulatory restrictions on competition including the price cap, and on possible measures to support vulnerable customers once the price cap has been removed.

10. Certain regulatory restrictions and distortions prevent fully effective competition

What, if anything, needs to be done to make competition in the retail market more effective? The EMI Final Report explained that Ofgem's simple tariffs policy had had an adverse effect on competition, as earlier did Ofgem's non-discrimination policy. Ofgem has since withdrawn these policies.

The most serious present restriction of competition is that caused by the PPM and default tariff caps. This needs no explanation here. There is already evidence of errors in setting the caps; they have led to the alignment of price-controlled tariffs; they have discouraged suppliers from innovating; and they have reduced customer switching, to mention just a few examples. The removal of the tariff caps is a prerequisite for making competition more effective.

Two other aspects of the regulatory framework distort or restrict competition, and should be removed or modified.

One distortion is the imposition of social and environmental costs on Large suppliers while Small suppliers are exempt. This measure was introduced in order to "encourage the smaller companies to grow" at the expense of the larger ones. The time and need for that has passed. The differential obligations mean that more efficient suppliers could appear to be less efficient. The low tariffs offered by exempt suppliers give a misleading impression of what competitive prices are. All suppliers need to be treated alike. To save an undue burden on the smallest suppliers, it might be possible to levy a charge in lieu, approximately equal to the cost of complying. But there is no longer a case for handicapping Large and Medium suppliers.

[8] E.g. One report found an annual switching rate of 18% for gas and electricity, compared to pay TV 10%, mobile networks 9% and fixed line telephone 5%. Social Market Foundation *Market Competition Bulletin* 2018, p 4. After a survey in March 2019, "nearly half (48%) of those surveyed said they have switched energy supplier in the last four years – significantly higher than those who said they had switched home insurance (35%), broadband (31%), telephone provider (24%) and bank (14%)". https://www.energyswitchguarantee.com/latest-news/nearly-half-of-energy-consumers-have-switched-according-to-new-survey/

The other major distortion is caused by lax compliance procedures in respect of environmental obligations. These obligations have been required and checked only after the end of each year. (This contrasts with the obligations for daily settlement of energy purchases.) Some smaller suppliers have had significant outstanding obligations, seem not to have been aware of the likely scale of these, and have consequently underpriced. Enforcement has dragged on over time. Some suppliers have charged what proved to be unviably low prices then gone out of business with substantial unpaid debts. Again this gives a misleading impression of what competitive prices are. It has also resulted in needless worry and inconvenience to the customers of the exiting suppliers.

Ofgem has taken some steps to tighten initial licensing procedures and to consult on ongoing requirements. But to make competition more effective it is not really more regulatory control over entry that is required, nor more ongoing supervision. The key is to ensure that payment for environmental and social obligations is prudently scheduled and enforced in a commercial manner, so that suppliers cannot build up a debt that they later cannot meet and that has to be paid for by other suppliers and their customers.

11. The smart meter roll-out

The Tariff Cap Act requires that Ofgem review whether conditions are in place for effective competition. This review "must, among other things, consider the extent to which progress has been made in installing smart meters for use by domestic customers." Importantly, the Act does not say that smart meters are a requirement for effective competition. It would be difficult to make such a claim, since competition in this sector was deemed effective (by the then Direct General of Electricity Supply) before smart meters were developed, and competition is effective in other sectors where smart meters have no relevance.

Is there any evidence that a more extensive roll-out of smart meters would make competition more effective? The second sentence of Ofgem's recent Open Letter on the smart meter roll-out says that "Smart metering brings immediate benefits to consumers, helping them to take control of their energy usage, and is a key enabler for the transition to a more flexible energy market and the move to a low carbon economy."[9] But there is no suggestion that smart metering increases competition.

More smart meters will bring quicker and more accurate bills, fewer estimated bills, and hence better customer service and fewer complaints. Against this, the ever-increasing cost of installing smart meters (and securing 24 hour switching at an estimated cost now approaching £0.5 billion) will mean higher customer bills. There may be advantage in terms of the variety of tariffs that can be offered, though experience in other markets with smart meters (such as Texas, Italy and Victoria) does not suggest that more than a negligible proportion of customers and suppliers will initially be interested in such tariffs. Some suppliers are now using smart meters to offer new PPM services (e.g. Utilita's new Power Up

[9] Ofgem, Smart Meter Rollout: Open letter on Energy Suppliers' Progress, Future Plans and Regulatory Obligations, 19 June 2019, available at https://www.ofgem.gov.uk/publications-and-updates/smart-meter-rollout-energy-suppliers-progress-and-future-plans-open-letter-june-2019

feature whereby PPM customers can apply for a top-up when they have run out of credit and need to get back on supply). These seem likely to characterise future competition in the PPM sector. And suppliers such as Octopus (with its Agile Octopus tariff) are demonstrating how smart meters can deliver a variety of environmental and efficiency benefits.

However, there seems no evidence that customers are more likely to switch, or engage in the market, or strengthen their "weak customer response", if more smart meters are installed. As Deller et al (2017) note (at p 5), the CMA itself took a similar view. Consequently, the state of the smart meter roll-out is not a reason to hold that competition is or is not effective.

12. What else could Ofgem usefully do to complement the development of competition?

The EMI Final Report considered that some customers might be missing out on better deals because they were unaware of them, or unduly worried about changing tariff or supplier. It recommended various ways in which Ofgem could encourage such customers to engage. These included facilitating more competition by Price Comparison Websites, establishing a Database Remedy, and setting up trials of collective switches offered to less engaged customers.

Such measures could be helpful to some sets of customers. Of course, other entities such as rival suppliers, Price Comparison Websites (PCWs), auto-switching services, Citizens Advice and Which? have every incentive to identify such customers and to try to assist them. Ofgem would need to consider where it could add value. One suggested possibility is a simple "league table" of customer service.[10] There might be concerns among suppliers generally if Ofgem's policy was to encourage customers to leave suppliers that they had been with for only three years.

From our perspective, the aim of such measures would not be to make competition in the market "effective", but rather to enable more customers to take better and earlier advantage of a market that is already effectively competitive.

13. Social and political judgements

The DP says that "Competition will not always deliver good outcomes for all consumers; some protection may be needed for those least able to represent their interests." (pp 6,7)

As is well known, the outcome of a competitive market will not necessarily coincide with some social or political judgement as to what a "good" or "fair" or "socially desirable" outcome would be.[11] Nor, indeed, does there seem to be much consensus on what would constitute such an outcome. For

[10] E.g. Stephen Littlechild, "Savings available in the retail energy market and the Overall Customer Service score", 12 February 2019, available at https://www.eprg.group.cam.ac.uk/report-savings-available-in-the-retail-energy-market-and-the-overall-customer-service-score-by-s-littlechild/

[11] C.f. "The traditional focus of economics on efficiency has never claimed that markets are effective tools for delivering equitable outcomes, …" *Fairness in Retail Energy Markets? Evidence from the UK*, Edited by David Deller and Catherine Waddams Price with Elizabeth Errington, Amelia Fletcher, Tom Hargreaves, Michael Harker, Noel Longhurst, David Reader and Glen Turner, Centre for Competition Policy, University of East Anglia, October 2018, Ch 1 p 14.

example, it might be argued that it would be fair for all customers to pay essentially the same price for energy. [12] But would that be fair to those customers that put more time and effort into exploring the offers available? If not, what price differential would be good or fair or socially desirable?

Perhaps certain categories of vulnerable customer should have additional assistance beyond encouraging them to participate more actively in the market. It is then up to the Government, working with Ofgem, to decide which categories of vulnerable customer should be assisted and how. In particular, insofar as the identified vulnerable customers are to pay lower prices than they otherwise would, is this to be paid for by taxpayers or by other customers?

These are not easy questions to answer. However, in our view it is more fruitful to focus on them explicitly, rather than on trying to circumvent them by inventing definitions or characterisations of "effective competition" that would deliver what (in Ofgem's view) might constitute socially or politically acceptable outcomes.

14. Ofgem's duty to recommend whether the tariff cap should be extended

The Tariff Cap Act provides for Ofgem to review whether conditions are in place for effective competition then to produce a report which must recommend whether or not the tariff cap conditions should be extended to have effect for the following year. The Act then requires the Secretary of State to say whether or not conditions are in place for effective competition, which determines whether or not the tariff cap ceases to have effect.

There is thus only one decision for the Secretary of State to make - whether or not conditions are in place for effective competition – and this translates automatically into whether or not the default tariff cap ceases to have effect.

In contrast, the Act does not impose such a limitation on Ofgem. That is, it would be open to Ofgem to carry out its review, conclude that conditions were not yet in place for effective competition, but nonetheless recommend that the tariff cap should not continue – for example, because of adverse effects associated with price control. Alternatively, it would be open to Ofgem to carry out its review, conclude that conditions were in place for effective competition, but nonetheless recommend that the tariff cap should continue, at least in some form – for example, to provide continued protection for specified vulnerable customers.

We are concerned that the DP focuses entirely on the conditions for effective competition. It shows no recognition that whether or not the tariff cap should be extended is a separate decision from whether the conditions for effective competition are in place. Consequently, the DP does not invite views on the criteria and evidence that should be used in deciding whether to recommend that the tariff cap conditions should be extended.

[12] "Parliamentarians have been clear that they think it unfair that some consumers should pay significantly more than others for the essential service of energy purely because they are unable or unwilling to shop around for cheaper deals." Dermot Nolan, Foreword to Deller and Waddams Price (eds), *Fairness in Retail Energy Markets? Evidence from the UK*.

The DP comments that "4.17. Since effective competition will not always deliver outcomes that meet the needs of consumers in vulnerable situations, provisions to complement effective competition may be required to ensure that they receive sufficient protection." Para 4.18 indicates that Ofgem (and BEIS) will consider elsewhere what these circumstances might be and what measures might be appropriate. In effect, this is a recognition that, even if Ofgem found that conditions for effective competition were in place, it might be concerned about automatically recommending that the tariff cap should be discontinued. It might therefore wish to make its recommendation about the continuation of the tariff cap conditional on some further measures being taken, for example with respect to specified vulnerable customers.

Similarly, Ofgem might not be convinced that the conditions for effective competition are fully in place, but nonetheless might be conscious of the adverse effects of continuing the price control.[13] Indeed, the EMI Final Report explicitly considered and rejected a price control on Standard Variable Tariffs, and the Minority Report of Professor Cave supported it only "for a short period – say two years". (EMI Final Report p 1416) Ofgem never advocated such a cap, and declined to introduce one until required to do so by the Tariff Cap Act. There might also be other adverse consequences of continuing the cap, the nature or extent of which had not previously been anticipated. For example, the cap has reportedly led to a reduction in energy suppliers' charitable donations to address problems of customer vulnerability. [14]

In order to inform its recommendation to the Secretary of State, we suggest that Ofgem should explicitly assess the pros and cons of continuing the tariff cap. To that end, it should take steps to assess the full range of impacts that the tariff cap is having. Some of these impacts will be picked up in making allowance for the extent to which competition would have developed in the absence of the cap. But as just illustrated, other effects would not be included in that calculation.

This leads to the question whether there are preferable alternatives to the tariff cap, alternatives that might provide desired protections for certain vulnerable customers without the adverse consequences associated with the present tariff cap. Dermot Nolan has suggested the importance of this.[15] Such alternatives might include tariff caps more narrowly focused on specified vulnerable customers. Or the

[13] This is a point made also by Deller et al (2017) p 10.

[14] "Price cap 'is leading to erosion of support for vulnerable customers'", James Wallin, *Utility Week*, 28 June 2019. At Utility Week's Consumer Vulnerability Conference, a speaker from Centrica said "The anecdotal evidence I am getting is that the price cap is having a devastating effect. Many charities that work in partnership with energy suppliers are saying that their funding is drying up. It's causing a real strain on energy suppliers so I'm worried that the effects of the price cap could see a reversal of a lot of the things that have been done around consumer vulnerability over the past few years." A speaker from Ofgem responded "Another thing it [the price cap] is trying to do is drive efficiencies in the sector. We set the cap at a level that presented a challenge to the sector and that challenge was to become more efficient. It's sad that maybe the place energy companies are going to achieve those efficiencies is to cut some of the support they are giving to vulnerable customers – either directly or through the charities they work with."

[15] "Ofgem CEO Dermot Nolan has said that finding a replacement for the price cap introduced at the start of the year in order to protect vulnerable customers is an absolute priority for the regulator over the next two to three years. He was speaking to the Commons Public Accounts Committee during an evidence session held on Monday 20 May. He described the price cap as having positive effects in the short-term but is capable of being gamed and limits innovation and efficiency in the long-term." (Cornwall Insight, Daily Bulletin, May 21, 2019)

appointment of a single supplier for specified vulnerable customers.[16] Perhaps a variant of the collective switch approach used in some of Ofgem's recent trials could be used to identify preferred suppliers for such customers and to discover the efficient costs of serving such customers.[17] The possibility of phasing out the tariff cap also merits attention.[18] In our view, Ofgem can only properly discharge its statutory duty to advise the Secretary of State whether or not to extend the tariff cap by considering also other potentially preferable alternatives to the tariff cap.

15. Conclusions

The Tariff Cap Act requires Ofgem to report on whether competition would be effective if the tariff cap were removed, not to design a new kind of competition that embodies socially desirable outcomes.

Rather than speculate on what effective competition would look like, it would be helpful for Ofgem to identify where it considers competition has not been effective hitherto. The Discussion Paper and the earlier EMI Final Report imply that this is the case in a number of respects, including a "two-tier" market, excessive price differentials, excessive profit margins, inefficiency and slow adjustment. We are not convinced by these suggestions. On the contrary, the competitive market process seems to be working well over time.

Competition could be made more effective, not only by removing the tariff cap, but also by removing two present distortions in the regulatory framework. These are associated with exemptions for small suppliers and with compliance procedures for environmental obligations.

Although Ofgem is required to report on the progress of the smart metering roll-out, this does not seem particularly relevant to effective competition.

The outcome of effective competition will not necessarily coincide with a social or political judgement as to what is socially desirable. Insofar as it is considered that certain vulnerable customers should have better outcomes, it is for Government to specify which customers, how this is to be brought about and at whose expense.

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[16] At the same Consumer Vulnerability Conference, the speaker from Centrica asked "Is there a group of customers – for example, those that are disengaged, pension credit customers, those with low educational attainment or learning difficulties – who ought to be taken out of the market altogether and placed with one supplier who is charged with safeguarding those customers so we no longer attempt to throw them into the mix?"

[17] E.g. Deller et al (2017) at pp 6-8. Also Stephen LIttlechild, "An energy price cap will damage the industry. Here's a viable alternative", *Daily Telegraph*, 9 January 2018, available at https://www.eprg.group.cam.ac.uk/article-an-energy-price-cap-will-damage-the-industry-heres-a-viable-alternative-by-s-littlechild/ And Stephen Littlechild, "Replacing the tariff cap and protecting vulnerable customers by more effective competition", 9 July 2019, available shortly at https://www.eprg.group.cam.ac.uk/tag/s-littlechild/

[18] Stephen Littlechild, Providing for a transition back to a competitive retail energy market: A response to the CMA's Invitation to Comment on its proposed review of the Prepayment Charges Restriction Order 2016, 17 January 2019, pp 15-17, available at https://www.eprg.group.cam.ac.uk/wp-content/uploads/2019/01/S.-Littlechild_CMA-with-PS-Jan19.pdf

The Act provides that Ofgem should make a recommendation about continuing or removing the tariff cap; this is separate from the question whether competition is effective. Ofgem should therefore examine and document more clearly the wider impacts of the cap, the pros and cons of extending it, and the possibility of replacing it by other measures.

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