What Would a Competitive Domestic Energy Retail Market Look Like?

Success metrics for retail market reform

By Simon Less

Summary of a roundtable discussion on 14 February 2013

Executive Summary

The proposed new regulation of the energy retail market, under Retail Market Reform, has been welcomed by some and roundly criticised by others. On 14 February Policy Exchange held a roundtable discussion to help stimulate debate on what success for these reforms would look like and how it could be measured.

The following key points were made at the roundtable (which do not necessarily reflect the views of Policy Exchange):[1]

- If we are to have a sensible debate about the state of competition, then we need to consider carefully the right set of measures that indicate the state of competition.
- The retail market, though not perfect, is generally healthy and continues to deliver for customers.

- The majority of customers were unlikely to benefit from Ofgem's Retail Market Reform proposals, and in particular vulnerable customers.
- Competitive markets are generally good at delivering efficiency, innovation and low average prices across all customer groups, but they are not good at making sure particular groups get particular outcomes. If helping vulnerable customers is the most important goal, focusing on the overall degree of competition is not in principle the best way to deliver this.
- The key may be to target help for vulnerable customers to access better terms that are already available in the market. Collective switching could provide a key approach, particularly if combined with an approach that encouraged local authorities, housing associations and others to help vulnerable customers switch, access lower tariffs and energy efficiency measures.
- We also need to be concerned about the barriers to the growth of new entrants. A key problem is the burden of regulation that kicks in once a small supplier reaches 250,000 customers, and the distortion to competition this creates.

We need to be able to distinguish in future whether the government reforms have been successful, have been insufficient or have made matters worse. Unless we are able to evaluate the reforms properly, there is a risk that yet further regulatory interventions will be demanded without understanding either the impacts of existing or proposed new regulation. This risks ongoing regulatory uncertainty and increasing unintended consequences from regulation.

Introduction

The policy debate about whether the domestic retail energy market is competitive continues unabated.

In autumn 2012, Ofgem published its latest Retail Market Reform proposals, including limiting to four the number of tariffs that energy companies can offer per fuel, and confirmed these in February. Also in February, the Government announced new Energy Bill clauses to take forward its proposals[2] to give itself 'backstop' powers, including to reduce the number of tariffs available and to ensure consumers cannot be left behind on expensive 'dead' tariffs.

This proposed new regulation of the energy market has been welcomed by some and roundly criticised by others.

On 14 February Policy Exchange held a roundtable discussion, including experts from academia, large and small energy suppliers, consumer groups and government. Its purpose was to help stimulate debate on what success for these reforms would look like:

- How will we know whether the reforms have succeeded, have been insufficient or have made matters worse?
- What evidence and metrics should we focus on?

This is important because we must understand the impact of regulation – its success or failure – if future policy is to be well informed, and to benefit, rather than damage, customers and the competitive process.

This note summarises, in the words of the author, some of the key points made at the roundtable (at which discussion was held under the Chatham House Rule). ***Points outlined in this summary do not necessarily reflect the views of Policy Exchange, nor of particular attendees at the roundtable.***

The appendix compiles a list of possible metrics for identifying the health of competition in the energy retail market, compiled by Policy Exchange and made available at the roundtable.

Opening remarks at the round table were made by Professor Catherine Waddams, of the ESRC Centre for Competition Policy at the University of East Anglia, and Ian Peters, Managing Director, Energy at British Gas.

Opening Remarks

Key points from Professor Waddams' opening remarks

- In a healthy competitive market, prices ought to follow the structure of, and changes to, costs. If the cost to energy suppliers of buying their wholesale energy falls, then prices ought to follow. Profits are essential for a market, but healthy competition should tend to erode profits to a 'normal' level.
- This is achieved through the threat of losing customers, including through market entry, eroding profits. This in turn requires customers to have a real choice to switch their supplier.
- Importantly, it is the credible threat of switching, or of entry, that is the critical element, not necessarily the actual exercise of switching or of entry. For a credible threat, there need to be low barriers to entry and to switching.

- How should we recognise a healthy market, including in 2017 when Ofgem has proposed to review the impact of its reform proposals?
- In principle, comparing UK energy prices levels with those in other countries, to ensure they are not unjustifiably higher, is a good approach. British prices look like they compare reasonably favourably. But there are practical measurement difficulties. Variations in taxes, energy policies and social obligations cloud the comparison. Energy markets are not particularly competitive in many other countries. Nevertheless comparing between countries the movements in retail energy prices would be useful.
- What about the level of customer switching? The peak level of switching in the domestic energy market has been around 20% per annum. This level is similar to that seen in other sectors, for example when a drug comes off patent, so may provide a benchmark.
- Overall what is most important is that customers are able to switch. So attention needs to be paid to barriers to switching, for example, complexity in pricing coupled with lack of access to price comparison websites. Removing relevant barriers is important, but will not necessarily show up in switching rates. Customers cannot be forced to switch.
- Centre for Competition Policy research is examining data from the Big Switch. Of customers who were presented 'on a plate' with savings of £60 or more per annum, only a third chose to go through with the switch. This was despite these being relatively active customers, receiving several reminders and needing only to fill in a very simple further form. It is therefore unrealistic to expect everyone to switch frequently. There is a cost to switching, in terms of people's time and effort. People have limited attention, and often life is too short! This doesn't mean that the market is not working.
- What about focusing on profit levels? The problem is that experience suggests where there is strong political and public focus on profits, reported profits tend to fall.
- What is the relevance of the price differential between active and inactive customers? This is a difficult issue. It is important to recognize that there needs to be a price differential to stimulate switching. Why switch if there is no benefit to doing so? Furthermore, we see in other markets that many people choose, or accept, significantly higher prices than are available.
- At the same time, fairness is a key part of the debate in relation to energy prices. Competitive markets are generally good at delivering efficiency, innovation and low overall prices, but they are not good at making sure particular groups get particular outcomes. If fairness is the most important goal, focusing on the degree of competition is not in principle the best way to deliver this.

- Measures specifically targeted to protect vulnerable customers could instead be taken, for example, helping vulnerable customers to participate in the market, doing so on their behalf, or other interventions to lower their bills. But care needs to be taken, as protection and competition do not sit easily together. Protection interventions that have a broad and significant impact on the market could produce the worst of all worlds.
- We also need to consider how the energy retail market could fundamentally change. For example, could it become a market for energy services, in the context of smart meters and demand for energy efficiency services? That could be a much more complex and innovative market, and this needs to be taken into account in thinking about what a successful market would look like in the future.

Key points from Ian Peters' opening remarks

- This roundtable discussion comes at a good time. Ofgem is poised soon to publish final proposals for Retail Market Reform. The Government published amendments to the Energy Bill only last week. If the Secretary of State is to be granted broad powers to reform tariffs, it is only reasonable there are objective criteria that indicate when such powers may need to be used.
- The retail market, though not perfect, has delivered and continues to deliver for customers. A wide range of indicators suggests competition is healthy. Energy prices continue to be amongst the lowest in Europe. Innovation continues apace, with new tariffs, new services such as remote control of heating, and roll out of smart meters paving the way for further innovation. There are more and larger entrants. Market share of small suppliers has more than doubled in 12 months, from 0.7% to 1.7%. Profit margins continue to be at low levels compared to other comparable sectors.
- However there is a perception that the market is not working well. This in part arises from the collision of rising energy prices and the economic downturn. But energy companies have a responsibility too.
- There is a view that lack of transparency and complexity in the energy market combine to create customer confusion. But, since 2010, companies have been changing and improving relationships with customers, including giving clearer information in bills, and providing simpler and fairer tariffs.
- We support the principles behind Retail Market Reform, particularly the need to promote clarity and simplicity. But many of Ofgem's proposals go well beyond this. The four-tariff cap and the banning of "bespoke" discounts and incentives may make tariffs simpler but there is

a material risk they will reduce innovation and switching, dampening engagement amongst some customer groups. Some customers expect to be offered incentives not to leave their supplier, or to join a new supplier.

- Particularly given these risks, we need to have clear measures of overall success. These should inform Ofgem's forthcoming Impact Assessment, and, post Retail Market Reform, they should be able to show whether it has met its objectives.
- The scale of reform being proposed is significant. The next 18 months will be a huge transition that we need to avoid repeating if possible. Government is proposing to take backstop powers but it should recognise that regulatory uncertainty can be damaging in terms of delaying investment and rollout of initiatives that benefit customers.
- A set of agreed measures of success could be helpful in providing some certainty. The options compiled by Policy Exchange (in the appendix to this report), and Ofgem's suggested enhanced monitoring criteria are useful starts.
- Historically, inter-supplier rates of switching have been the primary indicator of competition working effectively. However, over-reliance on this single metric could be misleading. Happier customers may switch company less. A range of measures is likely to be necessary. Intra-supplier switching – between different tariffs – should be given more prominence.
- If we are to have a sensible debate about the state of competition, then we need to consider carefully the right set of measures that indicate the state of competition. Failure to do so could encourage "knee jerk" responses to single measures – which may end up doing more harm than good.

Key Points Made in Discussion

A range of points was made in discussion, including those summarised below.

Case for Retail Market Reform

- Work was undertaken for Ofgem, around 10 years ago, to develop criteria for a competitive market. These included whether prices changed as costs changed and whether there was innovation to meet customers' needs and concerns. On the basis of these criteria, the market currently passes with flying colours.
- Ofgem's proposals aim to eliminate all gains and losses from choosing to switch / not switch, so there will be no reason for customers to make the effort to switch, reducing competition.

The majority of customers will not benefit from Ofgem's Retail Market Reform proposals. The proposals will not help the vulnerable, and may "destroy" the market for the rest.

Government vs energy companies

- Energy prices have doubled over the last few years. This has been driven by rises in international energy prices and by government energy policies. Would we be having the debate about the health of competition in the energy market if prices had not risen? It has been convenient for government to suggest that companies, through manipulating the competitive market, are to blame for rising prices.
- It was reported that at least one large international energy company has considered entering the UK market. But having undertaking a long and in depth assessment, they walked away because of the regulatory uncertainty arising from government and because in the prevailing UK context "they wouldn't be allowed to make money".

Vulnerable customers

- The market has been innovating to try to meet the needs of inactive, including vulnerable, customers. Companies put together eye-catching packages, including large upfront discounts, to attract relatively inactive customers to switch. Switching sites innovated, for example to enable customers to set the saving level they sought, so that they would be contacted and switched when that saving became available. The question is whether this activity by companies and by switching websites was more likely to succeed than Ofgem's proposed regulatory approach?
- While there was a great deal of complexity in tariffs, only a small fraction of tariffs were available to pre-payment and cash customers. Is trying to manipulate the competitive market - for example through restrictions on tariff numbers - the right approach to delivering social policy goals? Ofgem's reforms are aimed at the middle classes. (But does it matter that only some customers will use improved information, as long those who don't are not worse off?)
- Market-oriented remedies, such better information, are insufficient to help vulnerable customers because they work only if customers can be motivated to switch. Should we take vulnerable customers out of the competitive energy market, for example with a mandated 'backstop tariff'? Two problems were raised with such an approach: One problem with policies to target interventions only on vulnerable customers is the difficulty in identifying vulnerable customers. (It is not the case that all people who do not switch are vulnerable.)

Second, the regulator would have serious difficulty in setting the right level for a backstop tariff. In analogous past situations, the relevant regulator was unable to do better than simply taking the prices in the market anyway.

- The key may be to target help for vulnerable customers to access better terms that are already available in the market. Collective switching could provide a key approach, particularly if combined with an approach that encouraged local authorities, housing associations and others to help vulnerable customers switch, access lower tariffs and energy efficiency measures.
- The energy industry does a great deal to try to address fuel poverty (particularly under regulatory requirements). But it cannot be expected to fix everything. Regulation that makes vulnerable customers uneconomic (such as the Warm Home Discount) could make matters worse, by ensuring that no company competed for their custom. Vulnerable customers lose the Warm Home Discount if they switch to one of the small suppliers.

New entrant suppliers

- We need to be concerned about the barriers to the growth of new entrants. There is currently a clear divide between large and very small companies. Should there be a broader spectrum of company sizes?
- A key problem is the burden of regulation that kicks in once a small supplier reaches 250,000 customers. For example the ECO programme alone can cost a company up to £100 per customer. Small suppliers are given a special exemption from these regulatory costs that larger companies have to pay. This gives small companies a competitive advantage. But as a small supplier grows, it has been estimated that, it would need to reach 750,000 customers before it regained the level of profitability it had at 249,999 customers. That is a huge disincentive for growth. One entrant is reported to have said, “I either get customers or make a profit”.

Wholesale market liquidity

- Is wholesale market liquidity an important metric for a healthy retail market? Low liquidity is an issue for small suppliers. But a number of small suppliers have been able to make progress recently in their ability to trade energy.

Policy Exchange Concluding Comment

Ofgem's proposals for market regulation, under Retail Market Reform, have been criticised from a number of quarters. Ofgem has yet adequately to set out how we will assess the success or failure of its proposals.

We need to be able to distinguish in future whether the reforms have been successful, have been insufficient or have made matters worse. Unless we are able to evaluate the reforms properly, there is a risk that yet further regulatory interventions will be demanded without understanding the impacts of existing regulation. This risks ongoing regulatory uncertainty and increasing unintended consequences from regulation.

Appendix

Possible metrics for the future health of competition in domestic energy retail markets:

Switching

- **Higher switching rates** – Switching helps drive competition. But would low switching be a sign of competition problems, competitive, keen prices or a consequence of tariff regulation?
- **Lower barriers to switching** – These may be more relevant than switching rates per se. But are they sufficiently well understood or measurable?
- **Better switching decisions** – It surely matters that most customer switching favours better, cheaper suppliers. But how critical are poor decisions currently to limiting competition?

Prices

- **Lower prices** – Would appear to be an ultimate goal. But can the health of the market be disentangled from other factors, such as international gas prices and policy costs?
- **Lower prices compared to other countries** – This might control for international gas prices. But can robust comparisons be made?
- **Lower price differentials between active and inactive customers** – This could signal the market working to keep inactive customers' prices low. But could it also reflect regulatory rules keeping active customers' prices high?

Services

- **More service choices and innovations** – This might generally be considered a characteristic of a healthy market. But would low innovation be a market or regulatory failure? Are more choices compatible with effective customer engagement in the market?

Market structure

- **More and/or growing new entrants** – Generally a healthy sign. But the optimal number of competitors differs by sector, and six is more than many apparently healthy markets?
- **Changes in market share** – Could signal active competition. But little change might signal price competitive market?
- **Barriers to entry** – May be more relevant than entry per se. But are they sufficiently well understood and measurable?

Customer satisfaction

- **Improved customer satisfaction** – Arguably an ultimate goal. But can the impact of the market be disentangled from other customer concerns, such as price volatility?
- **Fewer (unresolved) complaints** – Important. But is it sufficient/central?
- **Increased levels of trust** – Public trust is an essential condition for an effective market. But is it sufficient, as there could be high public trust in a monopoly market?

Profits

- **Lower supplier margins** – Low economic rents would suggest a competitive market. But can they be properly assessed in vertically integrated companies?

Further Reading

Simon Less (2012), Retail Market Reform and the Future Shape of the Domestic Energy Retail Market: Summary of a roundtable discussion on 29th May 2012, Policy Exchange www.policyexchange.org.uk/images/publications/retail%20market%20review%20events%20summary%20publication.pdf

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Endnotes

[1] Ofgem (2012), The Retail Market Review – Updated domestic proposals www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=300&refer=Markets/RetMkts/rmr

[2] DECC (2012), Ensuring a better deal for energy consumers: DECC Discussion document www.gov.uk/government/uploads/system/uploads/attachment_data/file/66515/6996-better-deal-energy-consumers.pdf

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