

Agenda

Advancing economics in business

Ofgem's Procrustean bed

As part of its retail market review, Ofgem, the energy regulator for Great Britain, has proposed to limit the number of standard energy tariffs available and to set the standing charge itself. Stephen Littlechild, Emeritus Professor, University of Birmingham, and Fellow, Judge Business School, University of Cambridge, examines whether these proposals will help consumers in practice

According to Greek legend, Procrustes had an iron bed in which he invited passers-by to spend the night. They were told that it had the unique property that it would exactly match the length of whoever lay in it. In the event, if they were too short or too tall, Procrustes stretched or amputated them to fit.

In a surprising regulatory innovation, Ofgem proposes a similar treatment for all retail energy suppliers and their domestic customers. All suppliers will be limited to one standard tariff per payment method. Each year Ofgem will specify a common monthly standing charge for all the suppliers' standard tariffs. Those suppliers whose standing charge is too high will have to reduce it; those with a low or zero standing charge will have to increase it.

The passers-by did not survive. What will happen to retail suppliers and domestic customers?

What has led Ofgem to this remarkable proposal?

Consumers have told us they would be far more likely to engage effectively in the market if it is easier to make comparisons between tariffs. In our quantitative research, 74 per cent of non-Economy 7 respondents and 76 per cent of Economy 7 respondents stated that they would be more likely to switch if a common standing charge and a price comparison metric were introduced.¹

Ofgem's quantitative research asked respondents to imagine that their electricity consumption was a specified number, chosen at random from 1,000 to

5,500kWh per year.² Unfortunately, this meant that a widowed pensioner on benefits could find herself being asked to judge the cheapest tariff for a family of six with an electrically heated swimming pool, and conversely. Respondents' own personal consumption and experience were thus rendered irrelevant.

The cited result is the view of the 39% of respondents who preferred a common standing charge and a price comparison guide. However, 61% of respondents did not prefer this combination, and were not asked their views about the effect of introducing it. A closer examination shows that the availability of a price comparison metric is what is driving the respondents in the survey. Imposing a common standing charge makes little difference.

How much weight should be attached to this research as a predictor of what customers would actually do, and hence as a guide to policy? What are we to make of a finding that about three-quarters of respondents say they would be more likely to switch if a price information guide were made available—*when such guides are widely available and used in the market already?*

Or, to take another example, should we place any weight on research that finds that only 6% of respondents would probably choose a variable tariff³—*when in reality about 75% of customers have actually chosen such a tariff?*

The quantitative research provides no basis for imposing a single tariff or for believing that consumers will be far more likely to engage effectively in the market if all suppliers are required to set a common standing charge.

This is a summary and slight extension of my response to Ofgem's Consultation on its Retail Market Domestic Proposals, submitted January 23rd 2012. The views expressed are my own.

What problem is thought to necessitate such intervention?

Ofgem's research says that customers are disillusioned and frustrated in the face of rising prices. This is quite understandable. The average energy bill has doubled over the last ten years. Ofgem has explained elsewhere, however, that this is due to rising international gas prices and government environmental and energy efficiency policy.⁴ The UK has not fared worse than other countries: Ofgem's figures show that UK electricity and gas prices compare very well against other European countries. Electricity prices have also followed fuel costs.⁵

What about other complaints that are sometimes heard? Energy prices go up faster than down? The evidence is mixed but there is also evidence that prices go up faster in over two-thirds of other markets that are not associated with market power.⁶

Customer switching rates have fallen? But they are still in line with the last decade and higher than in almost all other countries. Great Britain is said to have the most competitive market in Europe.⁷

Excessive profits? Not according to Ofgem's own calculations: average net profit margins have been very low, and, on dual fuel, largely negative.⁸

'Sticky' customers who do not switch get worse terms than active customers? But that is true in all markets. Suppliers have to offer better deals to active customers, otherwise they lose them. However, suppliers cannot let their prices to sticky customers get too far out of line with the prices that obtain for active switchers, because even sticky customers can switch.

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.⁹ This is better than in many other markets. Sticky customers are, in fact, well protected in the UK energy market. It is simply not necessary for most customers to keep switching in order to get the benefits of retail competition.

Is Ofgem's previous experience encouraging?

Has Ofgem's previous manipulation of the retail market benefited customers? The evidence suggests not. Until 2009, suppliers were cutting prices to compete outside of their local areas. Ofgem objected to them not also cutting prices within-area, and introduced a non-discrimination requirement. Economists warned that enforcing equal prices would lead to the removal

of the lower prices rather than the higher ones—there would be less competition and higher profit margins.

It seems that the economists were right: the average net profit margin has indeed increased since 2009.¹⁰ Furthermore, as suppliers sought other ways to compete despite Ofgem's non-discrimination restriction, they introduced a greater variety of tariffs. Thus, Ofgem's own action induced precisely the proliferation of tariffs that it now complains about and seeks to prevent.

Have other regulators had better experience of nudging customers?

Ofgem explains that its policy in the retail market is informed by insights from behavioural economics.¹¹ On the basis that a common standing charge and a price comparison metric would significantly improve consumer decision-making, 'we need to nudge consumers to engage with this information to compare tariffs' (para 2.8). Ofgem's review of 'behavioural economics in practice' gives two examples of such attempts to influence consumer decision-making, as actually carried out by another UK regulator.

The Financial Services Authority (FSA) commissioned studies to examine the impact of extra information on consumers' decisions to purchase insurance,¹² and the impact of providing extra and standardised information to consumers on their decisions to purchase mortgages.¹³ Ofgem describes these studies in the following way.¹⁴

5.16. The [first study] found that providing extra information about the product's value for money (claims ratio) and the sellers' incentives (commission) had no real impact upon purchasing decisions. Consumers recognised this information was important but were unable to use it in a consistent manner to change their behaviour. However, this extra information did make consumers feel less confident about the decisions that they made. This means that the overall impact of more information on consumer wellbeing was ambiguous. While consumers valued having the information, or recognised its importance, it did not enable them to change their decisions and they became less happy about their actions.

5.17. ... [The second study] found that after MCOB [Mortgage Conduct of Business regulation] there were better mortgages available in the market. However, mortgage prices increased after MCOB. They concluded that this could have reflected costs of MCOB being passed through by lenders. They also found that after MCOB, consumers bought mortgages that offered poorer value for money to them.

5.18. These findings indicate that consumers value having greater access to information they think is important. However, they have limited capacity to process extra information when making their purchase decisions. The second study also highlighted that providing this information can be costly. Further, it is possible that extra information can harm consumers' feelings of wellbeing.

These outcomes should give pause for thought—and a recent review of the implications of behavioural economics by two former US regulators at the Federal Trade Commission offers another warning:¹⁵

Flawed heuristics and myopia are likely to lead regulators to adopt policies closer to the preferences of political overseers than they would otherwise. The incentive structure for regulators is likely to reward those who adopt politically expedient policies, either intentionally (due to a desire to please the political overseer) or accidentally (due to bounded rationality).

What about the tariff innovations that competition has already provided?

Retail competition has encouraged suppliers to provide new tariffs, geared to the different needs of different customers. The most popular—confirmed by Ofgem's Ipsos MORI study—are:

- tariffs with no standing charge, so that the total bill is under the control of customers;
- discounts for online purchase, to recognise the cost savings and customer cooperation involved;
- discounts for dual fuel, for the same reasons; and
- green tariffs, to make a contribution to the environment.

Ofgem proposes that standard tariffs with these four features should be prohibited. At a stroke, the four most important and valued tariff innovations that retail competition has brought to the UK are to be abolished. How is this consistent with promoting competition and the interests of customers?

What are the costs and consequences of Ofgem's proposal?

Ofgem acknowledges that its proposal will increase the risks and costs to suppliers, and to smaller suppliers in particular. These additional costs and risks will, of course, be passed through to customers. The proposal will also increase the regulatory burden and Ofgem's own costs. These, too, will be charged to suppliers, and hence to customers.

With Ofgem now determining which standard tariffs are allowed and which are not, and setting a common standing charge for all of them, a significant component of the retail energy market price becomes the direct responsibility of the regulator. Ofgem's actions would have immediate implications for different types of customer and different suppliers. This can be expected to increase the extent of lobbying, with requests to reduce or increase standing charges, and to allow or disallow exceptions or modifications. Regulatory costs and risks would increase accordingly.

The standing charges and types of tariff allowed will become an annual media event. The regulator will surely discuss its thinking with the energy minister. Energy prices will, once again, be a political decision.

Before proceeding down this road, let us remind ourselves what electricity pricing used to be like under government ownership, and why privatisation and competition were deemed so necessary to remedy the situation. Until the late 1980s, energy prices were increased, decreased or left alone according to what was politically convenient at the time. The consequences included an ambiguity about economic and financial responsibility throughout the sector; prices that reflected political convenience rather than costs, both at the aggregate level and by individual tariff; a systematic suppression of vital information about the costs of different technologies; and a consequent series of poorly informed investment decisions that significantly increased the costs to customers over the longer term.

Facing reality

Recent energy price increases have reflected world fuel prices and government policy, not a failure of the retail energy market. Rather than shoot the messenger, let us be grateful that the retail market is telling us what energy costs actually are.

The competitive retail market is incentivising suppliers to keep down wholesale and retail costs where they can, and to offer to customers the best deals they can provide. Even the most active retail market imaginable—hypothetically, for example, one in which all customers received the best price in the market rather than the average retail price—would have made not a jot of difference to the impact of the two main causal factors identified; or to the broad pattern of wholesale and retail prices over the last decade; or to the present extent of consumer disillusion and frustration.

Customers are understandably upset about rising energy prices, and many customers are indeed sticky. However, there is no evidence that they are more sticky in energy than in other sectors: 77% of

customers that have not switched supplier say they are happy with their supplier;¹⁶ 92% agree that 'once I find a product that I think is OK I tend to stick with it'.¹⁷

Arguably, customers are more realistic than Ofgem. They know that switching can reduce their tariff, and those customers that think this worthwhile have switched and continue to do so. But they do not kid themselves that switching will turn back the tide of rising wholesale and network prices.

There is no reason to believe that restricting each supplier to one standard tariff, having Ofgem dictate a common standing charge each year, and imposing a raft of other restrictions on suppliers, will encourage more customers to engage actively in the market. Amputating the retail market in a desperate attempt 'to nudge consumers to engage with this information to compare tariffs'¹⁸ has got the situation out of perspective. It has confused the ends and the means. It will make the situation worse for customers, not better.

How best to deal with complexity and choice?

There must surely be a better policy than one that manages to combine Greek mythology, Luddism and post-war Soviet control. Can we not find a policy more suited to the thinking and conditions of the 21st century?

Future wholesale market conditions are unknown and may well be adverse. Technological change is inevitable but unpredictable. Elsewhere, Ofgem draws attention to the roll-out of smart meters and the increased opportunities for demand-side participation. Innovation, complexity and choice will increase, not decrease.

In these difficult and unfamiliar circumstances, a significant challenge is to discover what kinds of retail products will give customers the protection and reassurance that they most value. Experience has shown that different customers have different priorities. Some prefer a fixed price but more do not. Some wish to be active but the majority do not—at least, not all the time. In Scandinavia, spot price deals have been more popular than expected. In the UK, where there has not been a widely accepted spot price, such deals have not yet emerged. Surely we will find better solutions to the different problems of different customers by encouraging suppliers to offer more variety, not less?

Many customers are confused by the number and variety of energy tariffs, as most of us are confused by the number and variety of prices and specifications for supermarket products, laptops or mortgages.

Economists have found errors and failures to choose the best energy deal, but this is increasingly recognised to be true of consumer behaviour generally, in all markets.¹⁹ That is why many customers are guided by habit, experience or reputation, rather than by a regular and detailed numerical comparison of all the offers available at any time. Sticky customers are not an aberration of the UK retail energy market: they are, and always have been, an intrinsic feature of all markets everywhere. But that has not led the Office of Fair Trading to insist on a uniform loaf of bread.

How best to cope with this mountain of confusing information? Surely we should build on the numerous comparison websites and advisory agencies that already exist? They are, in effect, competing with each other to discover and provide the means of comparison and choice that customers themselves deem most understandable and relevant. Surely there is scope for Ofgem to work with suppliers and such agencies to achieve greater transparency and customer satisfaction without restricting innovation and differentiation that meets customer preferences?

A stimulating example of this has emerged since my evidence was submitted to Ofgem. Which? has invited customers to sign up for The Big Switch.²⁰ It will then collectively negotiate the best deal possible from all the energy suppliers. Ofgem has encouraged this, as have UK politicians from various parties.

At the same time, there is important work for Ofgem to do elsewhere. It is considering the possibility of reforms to the cashout mechanism that could provide a spot price, increase liquidity and facilitate the entry of new and smaller players into the retail market. It also needs to consider how best to protect the interests of consumers and promote effective competition in the context of the government's evolving energy policy, not least in setting network price controls.

An alternative proposal for policy

Ofgem's consultation mentions the possibility of a Competition Commission review.²¹ This would be time-consuming and costly, but it would enable a more dispassionate analysis. Ofgem's proposals are so extreme, and so inconsistent with the interests of customers and the promotion of competition, and the case for them is so implausible, that it would be preferable that another body should first take a more considered look at the situation. However, another policy option may be worth considering.

In the Greek legend, Procrustes' reign of terror was ended by Theseus, who turned the tables on him, fatally adjusting him to fit his own bed. Only partly inspired by Theseus, here is a suggestion for

addressing Ofgem's concerns that particular customers may be disadvantaged at present.

Let the six major energy suppliers each put up £1m to establish a new energy supplier, whose directors are to be nominated by Ofgem and the various consumer representative groups such as Consumer Focus, Citizens Advice and Age UK. The new supplier will adopt whatever purchasing policy, price offerings, terms and conditions, and sales promotion strategies that these organisations consider will best protect the interests of customers, particularly vulnerable ones. Or—a less expensive option—let the new supplier act on a 'white label' basis, repackaging the offerings of other existing suppliers. Or let it simply engage in negotiation and recommendation, as an enhanced version of the recent Which? proposal. The sole restriction on the new supplier's activities, other than the normal retail licence conditions, is that it should earn a reasonable return on the initial capital and not

run at a loss. The aim is certainly not to undermine existing small competitors.

With this regulatory-approved option now available to all customers, Ofgem can drop its proposed restrictions on retail services and suppliers. Customers can be reassured that the new supplier will try to offer them the best terms that the market can provide, and will not exploit them. The new supplier's terms may become a benchmark against which the terms of other suppliers may be compared. The experience of this supplier will also provide customers, their representative organisations and, not least, Ofgem itself, with a better understanding of the challenges facing all retail suppliers.

In this way, vulnerable customers would be directly protected. Better understanding of the retail market would be available to all. And domestic customers would sleep more safely in their beds.

Stephen Littlechild

¹ Ofgem (2011), 'The Retail Market Review: Domestic Proposals', Ref 166/11, December 1st, p. 10, para 2.8. Subsequent quotations are from this document unless otherwise noted.

² Ipsos MORI (2011), 'Consumer Reactions to Varying Tariff Comparability', quantitative research conducted for Ofgem, October 18th.

³ *Ibid.*, p. 26, table.

⁴ Ofgem (2011), 'Why are Energy Prices Rising?', Factsheet 108, October 14th.

⁵ Department of Energy and Climate Change (2010), 'Electricity Market Reform: Consultation Document', Cm 7983, December, p. 22, para 13.

⁶ Peltzman, S. (2000), 'Prices Rise Faster than they Fall', *Journal of Political Economy*, 108:3, June.

⁷ Department of Energy and Climate Change (2010), 'Consultation on the Implementation of the EU Third Internal Energy Package', July.

⁸ Ofgem (2011), 'The Retail Market Review – Findings and Initial Proposals', March, p. 43, Figure 2.13.

⁹ For example, Ofgem (2011), 'The Retail Market Review – Findings and Initial Proposals', March, p. 35, Figure 2.8.

¹⁰ Hviid, M. and Waddams Price, C. (2010), 'Non-discrimination Clauses in the Retail Energy Sector', CCP Working Paper 10–18, November, forthcoming in *The Economic Journal*.

¹¹ Ofgem (2011), 'What can Behavioural Economics say about GB Energy Consumers?', March 21st, Appendix 1: Behavioural Economics in Practice, pp. 21–2.

¹² Meza, D., Irelenbusch, B. and Reyniers, D. (2007), 'Information versus Persuasion: Experimental Evidence on Salesmanship, Mandatory Disclosure and the Purchase of Income and Loan Payment Protection Insurance', FSA.

¹³ Monteiro, N. and Zaidi, R. (2007), 'Market Impacts of MCOB', *FSA Occasional Paper Series*, 27, August.

¹⁴ Ofgem (2011), 'What can Behavioural Economics say about GB Energy Consumers?', March 21st, Appendix 1: Behavioural Economics in Practice, pp. 21–2.

¹⁵ Cooper, J.C. and Kovacic, W.E. (2012), 'Behavioral Economics: Implications for Regulatory Behaviour', *Journal of Regulatory Economics*, 41, pp. 41–58.

¹⁶ Ipsos MORI (2011), 'Customer Engagement with the Energy Market – Tracking Survey', January.

¹⁷ Ball, C., Hviid, M., Loomes, G. and Waddams, C. (2011), 'The Retail Market Review – Findings and Initial Proposals', response to consultation, Centre for Competition Policy (University of East Anglia), June.

¹⁸ Ofgem (2011), 'What can Behavioural Economics say about GB Energy Consumers?', March 21st, Appendix 1: Behavioural Economics in Practice, pp. 21–2, para 2.8.

¹⁹ For example, Ofgem (2011), 'What can Behavioural Economics say about GB Energy Consumers?', March 21st. Kahneman, D. (2011), *Thinking, Fast and Slow*, Allen Lane.

²⁰ See <http://www.which.co.uk/news/2012/02/join-the-big-switch-to-cut-your-energy-bills-278444/>.

²¹ Ofgem (2011), 'The Retail Market Review: Domestic Proposals', Ref 166/11, December 1st.

If you have any questions regarding the issues raised in this article, please contact the editor, Leonardo Mautino: tel +44 (0) 1865 253 000 or email l_mautino@oxera.com

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