Submission to Ofgem

Providing financial protection to more vulnerable consumers

8th January 2018

For some time I have been arguing for an intervention in the UK retail energy market.

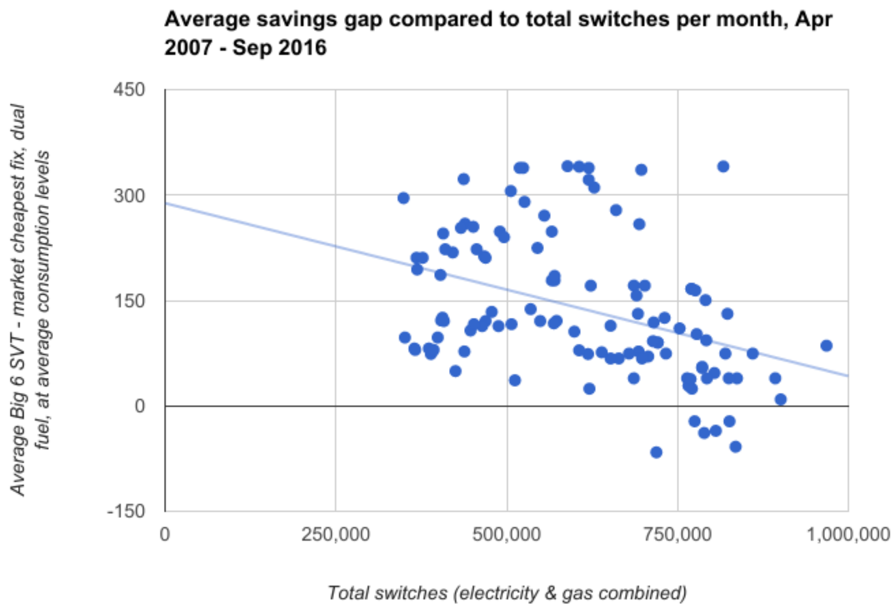
After the Government's June 2014 referral of the UK energy market to the Competition and Markets Authority (CMA), the Energy Market Investigation Final Report (June 2016) identified an extremely high level of consumer detriment, where a very large majority of the entire population of the country are getting a bad deal from their energy firm. An essential purchase required by every citizen is widely and systematically over-priced (spending on energy in poorer households has risen from 5.5% income in 2004 to almost 10% in 2015), making it harder to create an economy that works for everyone, and reducing the UK's overall economic productivity as well.

Very few other sectors systematically exploit – rather than reward – loyal customers by capitalising on their inertia in the way out-of-contract customers are currently penalised by high Standard Variable Tariff (SVT) prices. The problem occurs in two ways:

- Where customers have explicitly chosen a cheaper fixed-term contract which comes to an end, they are then switched to the more expensive SVT unless they intervene tio choose something else. Pure inertia selling is illegal in most markets, and switching customers onto a different – and usually much pricier – tariff without their explicit consent at or near the moment of change makes people feel ripped off.
- Where customers have never switched, they remain on the expensive SVT for many years. The amount of switching has been rising, but mostly because the same bargain hunters are churning round in ever-faster circles between different energy firms. The CMA found that 90% of UK domestic energy customers are entirely disengaged and unable or unwilling to switch energy providers: "In our survey of 7,000 domestic customers, 34% of respondents said they had never considered switching supplier and 56% said they had never switched supplier, did not know if it was possible or did not know if they had done so."

Cap or No Cap?

Some commentators have argued that there should be no cap at all, because any consumer can switch at any time. But that assumes the energy market works in favour of consumers and, as the chart provided by *Citizen's Advice* shows, at the moment it doesn't.



The chart shows a small ***negative*** correlation between the size of savings from switching and the number of people doing so. In other words, the amount of switching does ***not*** increase as the size of the potential cost savings rises. There is probably a minimum level of cost saving required before people will bother to switch (most market participants estimate £100 is plenty for a typical household contract) but expecting more people to start switching once the size of potential savings becomes large enough won't work as things currently stand. We need to fix the market's fundamentals first.

Permanent or Temporary?

The government's draft Bill rightly proposes that any cap should only be temporary, while we make longer term, structural changes to fix this broken market. Faster, cheaper, more reliable switching, backed by smart meters and simpler, clearer energy bills are all essential steps which were proposed by the CMA and are being introduced by Ofgem. But these changes will take years to transform the market and, in the meantime, there are 17 million households paying £1.4bn too much for their energy every year. A temporary price cap protects them until the structural changes make rip-offs impossible.

Absolute or Relative?

The government's draft Bill proposes an absolute price cap, where regulators meet every 6 months and pick a number. It has a number of serious disadvantages:

- It will reduce competition because supplier prices will cluster around a single number rather than pricing off each one's best competitive deal. Suppliers will sit at the "regulatory" level with little incentive to become more efficient.

- It will be more vulnerable to politics and lobbying, because it is set by regulators rather than customers. And the big 6 have far bigger teams of lobbyists than the challengers;

- It will effectively prohibit any firms that want to offer a premium but high cost product

- It's a highly distorting approach which replaces daily market-derived prices with infrequent regulator-derived ones, which throttles competition by being far less good at discovering and then meeting consumer needs.

- The capped prices will be out of date as soon as wholesale gas prices change (which happens every day)

I was delighted to see that Ofgem is now considering a close cousin of the relative price cap in paragraph 3.7 of its report (page 23):

> ***Basket of market tariffs.*** *This approach would calculate the benchmark based on a basket of tariffs available in the market at a given point in time (meeting certain criteria, eg cheapest). We would collect information on these tariffs at regular intervals to ensure that changing market conditions were reflected in the safeguard tariff.*

This recommendation is a small step in the right direction. Ofgem has accepted the 2-tier market needs to end, and that underlying pro-consumer changes are needed. A 'basket of market tariffs' is based on market-derived prices, rather than regulators making up a number. But the basket:

1. would have to contain only prices from the competitive part of the 2-tier market;
2. would be repriced according to the regulator's timetable rather than when needed for each supplier to grasp their particular (and different) competitive opportunities, or often enough to deal with daily or hourly fluctuations in wholesale prices; and
3. would harm competition more seriously than a relative cap because there would only be one upper price limit for the entire market, rather than different ones for each supplier, so we'd still expect to see 'bunching'.

My relative cap proposal fixes a maximum mark-up between each supplier's best competitive price and their default tariff. That means it protects customers who don't switch from being ripped off, but still leaves a worthwhile incentive for those that do.

- It restores the link between the prices which companies advertise in the marketplace and those which they charge the majority of their customers, incentivising efficiency and restoring competitiveness to the market for "back book" customers.

- It allows more price competition – suppliers won't be able to overcharge loyal customers without their informed and explicit consent at the moment of change, as they do at present.

- It doesn't limit the number & type of tariffs – suppliers would retain control over tariffs so they could still innovate and react to any sudden cost increases;

- It encourages innovation & fresh thinking and will reward efficient business models – those that maintain high SVTs will rapidly lose market share;

- It is always an up to date & accurate expression of current open competitive market prices, because it bases SVT prices on a genuine competitive price and so will simply be better (more accurate) than any absolute cap proposal,

- It provides much less scope for politics and lobbying of officials, regulators or politicians by the biggest producers with the largest lobbying budgets and best access.

- It provides less scope for regulators to make honest but still hugely damaging mistakes & errors. Even the best regulators can only calculate an approximation to the true competitive market price and, with the best will in the world, make plenty of mistakes.

- It won't get out of date as wholesale gas prices change, because it is based on the only genuinely market-driven prices in the retail energy sector – the fixed-term switching deals where more than 50 firms vie for customers every day – and competition is kept red-hot by price-comparison sites that continuously advertise the best deals.

Because of these competitive foundations, a relative cap creates a more effective long-term guarantee of low prices and good deals for customers than any price decision by a regulator, however clever and well-intentioned they may be. By forging a link between the highly-competitive part of the energy market, and the currently uncompetitive (and therefore rip-off) default tariffs, a relative cap imports strong competition from fixed term switching deals, and applies it to default tariffs too. It would make energy behave in the same way as any normal product, where those of us who don't switch (for example) our brand of coffee or cornflakes each week nonetheless benefit from the keen pricing which the manufacturers are forced to apply to attract the business of those who do.

Other People Agree

We must remember that the whole point of these reforms is that we're trying to unleash the talents of the fresh, new competitors - the challenger energy firms. They want the cap to be relative and temporary, which should tell us we're on the right track. *Policy Exchange* supports the case:

> **Energy price cap should be relative, not absolute,** *Policy Exchange*, 25th April 2017, https://policyexchange.org.uk/energy-price-cap-should-be-relative-not-absolute/

and even some of the Big 6 have expressed to me in private their support for the relative as opposed to the absolute model. Below are the comments given to me by the challenger energy companies.

Greg Jackson, founder and CEO of Octopus Energy: *“This relative price cap proposal will turbocharge competition for the benefit of all customers - bringing prices down for everyone. We will finally see which suppliers are efficient and which are not fit for purpose. And that's what the Big 6 are really scared of: transparency and competition."*

Bill Bullen, founder and CEO of Utilita: *"A relative price cap will stop the Big Six blocking competition whilst ripping off a big proportion of their customers. It will leave the market to operate, and everyone will benefit."*

Adrian Leaker, Managing Director of PFP Energy: *""[T]he majority of the Big 6 energy suppliers increased their prices for Standard Variable Tariffs, in their words “to cover rising costs”, however at the same time, some of the Big Six have been lowering their prices to acquire new customers on cheaper fixed price tariffs. In our view, this is not treating customers fairly and so we believe a relative price cap is an appropriate action and support curbing this inappropriate behaviour."*

Simon Oscroft, Co-founder of So Energy: *"For years, the Big Six have been protecting their market share by fleecing their loyal customers for hundreds of pounds, and charging new customers at a much lower rate. This is clearly not a fair or well-functioning market. A relative price cap would certainly go a long way to address this."*

Phil Levermore, Founder and Managing Director of Ebico: *"The relative price cap is a policy which could turn the tide against the big six business model, whereby higher margins generated from loyal customers on standard variable tariffs are used to subsidise cheaper prices for switchers, and it could achieve this without hindering competition and innovation."*

Keith Bastian, Founder and CEO Fischer Energy:

"The Big 6 have been ripping off their most loyal customers for years, and it is clear that something needs to be done. The relative price cap is the best way to bring about the change hard pressed energy customers so desperately need."

Chris Bowden, CEO and Founder, Squeaky Clean Energy: *"Whilst we are not in favour of an absolute price cap as we believe it would be very difficult to administer and potentially damage competition and innovation in the market, we would welcome a relative price cap."*

Amit Gudka Co-founder of Bulb Energy: *"We applaud John Penrose's proposal of a link between SVTs and the cheapest tariff. We believe it will help everyone benefit from lower energy prices and create a fairer and more transparent energy market. At Bulb, we're dedicated to lowering our costs and passing savings on to our customers and we believe this change would force other suppliers to do the same."*

Juliet Davenport, Founder and CEO of Good Energy: *“For years the plan of the ‘Big 6’ has been to attract new customers with cheap rates and then quietly shift them onto more expensive deals. In fact, a ‘Big 6’ CEO once boasted to me that his company offered both the cheapest and the most expensive tariff on the market.*

"This behaviour is not only unfair, it shows a complete lack of respect for your customers. At Good Energy, we support a relative price cap because it’s a simple idea to make the energy market fairer and to stop unscrupulous companies from exploiting their customers.”

CEO of Utility Warehouse, Andrew Lindsay: *"We strongly endorse the proposed introduction of a relative price cap. This practical solution will create a fairer energy market and promote competition, whilst helping to protect customers who have little desire to switch supplier on a regular basis.*

Dale Vince, founder of Ecotricity: *"A relative price cap is a great idea and something Ecotricity have suggested before. By dealing with the price gouging of the Big Six and many of new entrants who protest otherwise, it means people will get a better deal. In the current market the cheapest deals are unrealistic to draw in business and the standard deals are unfair on those who don't switch. A relative price cap that reduces the difference between the two extremes makes the whole industry more fair.*