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Energy supply: when can increased regulation promote competition?

Ofgem's Retail Market Review has raised further concern about the functioning of the energy supply market since its Supply Probe in 2008, and has proposed a further set of interventions intended to protect consumers. This apparent shift in approach away from competition-based intervention and towards consumer protection policy is examined here as an accompaniment to Ofgem's account of the Review published in this month's *Agenda*. The similarities and tensions between the two approaches are drawn out, together with some of the risks that could warrant further investigation

The removal of price regulation from energy supply in 2002 was accompanied by the prospect of consumer protection through effective competition, and welfare gains from greater choice through innovation and new tariff offerings. Ofgem stated the following:

> In early 2002 it was already clear that competition was bringing substantial benefits to customers, including vulnerable customer groups. These benefits already included substantial price competition, and it was evident that suppliers were investing and innovating as a result of competitive pressure [...] on-going price controls posed serious risks of braking or throwing into reverse the development of competition. These risks were judged to be the more serious if regulation were to be more tightly focused on prices paid by particular customer groups.[1]

Consumer groups and the regulator have, however, been dissatisfied with the market outcomes since these reforms:

- Ofgem's market investigation in 2005 followed a 'super-complaint' from energywatch that the industry's billing process was detrimental to consumers;[2]
- fines were levied on a number of suppliers for mis-selling;[3] and, more recently,
- new regulations restricting price discrimination and the number of evergreen tariff offerings were enacted or proposed though the regulator's Supply Probe in 2008[4] and its Retail Market Review (RMR) in 2011.[5]

A feature of the reforms proposed since 2008 has been to restrict the behaviour of suppliers and constrain the choice set for consumers. Such restrictions are consistent with a shift in approach away from a primary reliance on competition to deliver improvements in consumer welfare, and towards an increasing focus on policies to protect consumers.

While competition policy and consumer protection policy share the same goal (to help markets work for consumers), tensions can exist between the two. Poorly designed consumer policy can impose additional costs, and lead to distortions that can harm consumers, including those that they are designed to protect. This article sets out these tensions and considers some of the potential risks from Ofgem's proposed interventions. It raises the question of how the regulatory and market structure might evolve under the current trajectory, and whether a more appropriate alternative might exist.

Tensions between competition policy and consumer protection

Ofgem's principal objective is to protect consumers by promoting competition wherever appropriate. The regulator is therefore required to assess the potential benefits of policies that would encourage competition, as well as whether there are other options that might better protect consumers, even if they do not promote competition.

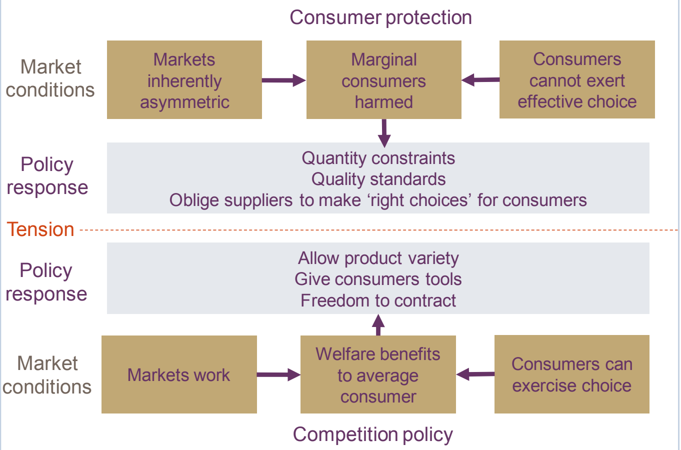
Competition policy and consumer protection policy are both designed to serve consumers, and to do so by helping markets work well. Effective competition means that customers can exercise their freedom of choice, and that companies will strive to provide better services in order to encourage customers to buy their services. With reasonably symmetric information, this freedom leads to gains from trade, and competition becomes a means to increased consumer welfare.

As recognised in Ofgem's work, consumer protection policy can complement competition policy by facilitating better choices: well-informed and empowered customers holding suppliers to account can help to deliver effective competition.[6] The three core aims of consumer protection policy are to prevent undue pressure on consumers (eg, through cooling-off periods), to help overcome pre-purchase information problems (eg, through trading and advertising standards), and to stop surprises post-purchase (ie, through the prevention of unfair terms).[7] These aims help to reduce the scope for suppliers to profit from taking advantage of uninformed consumers, and encourage more responsive demand, which provides sharper signals to suppliers to provide the right mix of services.

Tensions can nevertheless arise between the two policy approaches, as summarised in Figure 1. The source of this tension is the view that information processing is inherently problematic for vulnerable or poorly informed consumers, with recent literature on behavioural economics identifying biases (such as limited capacity to process information, loss aversion, and a preference to remain with the status quo) that may lie behind this poor decision-making.[8] As such, these consumer groups cannot exert effective choice, and could thus be harmed in the absence of further intervention. One policy response is to restrict consumer choice so that the regulator or supplier provides the 'right' set of products for the consumer.

In contrast, those who see competition policy as the key to increasing consumer welfare argue that many

Figure 1 Sources of tension



Source: Oxera.

consumers are in the best position to determine their own needs, and that there is value in product variety. From this standpoint, appropriate intervention should not limit choice, but should support consumers in making effective choices.

Competitive markets with information asymmetries, or where consumers have biases in decision-making, may fail some consumers. In a market in which all suppliers sell identical products but at different prices, and not all consumers know all of the prices being offered, it can be shown that more competition (in this case the number of alternative offers) can decrease the average price paid by informed consumers, but increase the average price paid by uninformed consumers.[9] A further result is that both informed and uninformed customers benefit as the proportion of uninformed customers decreases. Recent research in behavioural economics indicates that the welfare effects depend very much on the nature of the bias.[10] A distributional issue therefore arises: which consumers should the policy-maker protect, and how?

There are a number of examples of poorly designed consumer policies creating distortions and harming consumers (including those that they are designed to protect them). Three such examples are as follows.[11]

- **Risks from restricting consumer choice**. Restricting choice can be highly redistributive, and harm consumers who vigorously defend their interests. An example of this is the introduction of minimum quality standards, which can harm those consumers who genuinely want a low-quality product. Such policies also risk becoming the 'thin end of the wedge', and can induce further regulatory intervention, as discussed in more detail below.

- **Risks from increased market transparency**. Greater transparency can help to increase the number of informed consumers, and lower prices for both informed and uninformed consumers. However, increased price competition can lower quality standards, and increased transparency can facilitate coordination and subsequently lower competition.

- **Moral hazard**. If consumers are 'over-protected' (ie, insulated from the consequences of making poor choices), they might not pay sufficient attention to the choices they make. As such, they may become less engaged, and fail to develop the skills acquired from engaging in the market, including learning from past mistakes.

These examples highlight that, despite having the right intentions, a number of interventions require careful consideration to understand their potentially adverse impacts. Some of the potential risks associated with the RMR are drawn out below.

The RMR proposals and their implications

As outlined in the accompanying article in this issue of *Agenda*, Ofgem's RMR has put forward some reforms in response to its concerns that the level of competition has not increased since its 2008 Supply Probe, and that supplier conduct has been poor.

Consumer research from Ofcom, the UK communications regulator, identifies that the behavioural biases that might cause customer inertia may be strongest in vulnerable customer groups, including those on low incomes and some older customers.[12] Given this, and Ofgem's estimate that 40–60% of all customers in the energy sector are disengaged from the market, there would appear to be a case for intervention.

A number of the policy proposals can be mapped broadly onto the consumer protection-based policies outlined above, which aim to restrict consumer choice and increase market transparency. Regarding the former, the following proposal has been put forward.

- **Tariff restrictions**. Suppliers would be limited in their ability to offer more than one standard, or 'evergreen', product per payment method. Ofgem notes that this 'would be a major reform impacting the 75% of customers currently on standard evergreen products'.[13]

As Ofgem concludes, such reforms may help disengaged customers to compare prices more easily, and identify whether savings can be made either by switching between tariffs offered by their current supplier, or by switching supplier.

The tariff restriction proposal does, however, share many of the features (and risks) of the Supply Probe's pricing restrictions. Ofgem's 2008 Supply Probe remedy to restrict pricing differentials between consumers has received much criticism in relation to its effects on competition. At the centre of the concerns is the possibility that pricing restrictions could encourage industry prices to converge at the levels previously offered to less price-sensitive customers, rather than the more keenly priced tariffs offered to more price-sensitive customers.

> The remedies [addressing concerns over unfair price differentials] run the risk of introducing considerable distortions into the market, and even of producing perverse effects of raising prepayment prices above the level which the competitive market might deliver.[14]

Figure 2 highlights these dynamics in a stylised two-firm framework. Given the requirement to remove a higher- or lower-priced tariff, each of the incumbent suppliers is faced with the following trade-off:

Figure 2 Illustrative pay-offs from tariff restrictions

		Firm 1	
		Offer high price	Offer low price
Firm 2	Offer high price	100, 100	50, 125
	Offer low price	125, 50	75, 75

Note: Pay-offs are shown for two identical firms, both serving a proportion of 'sticky', price-insensitive customers, and a remaining proportion of price-sensitive customers. Each firm has the choice to offer a high price or a low price. If both firms offer a high price, each firm's share of customers remains the same and profits increase. If one firm offers a low price and the other offers a high price, the low-price firm gains price-sensitive customers from the high-price firm, but loses its high margin on its sticky customers. The lost profit on its sticky customers is assumed to be greater than the increased profit from attracting more price-sensitive customers.
Source: Oxera.

- the pay-off from offering a lower-priced tariff to all of its customers, thereby losing revenue on the less price-sensitive customers but maintaining or increasing its share of the more price-sensitive customers; and
- the pay-off from offering a higher-priced tariff, maintaining the margin on less price-sensitive customers but potentially losing a share of its more price-sensitive customers.

Critical to the equilibrium market outcome in this analysis is each firm's share of non-price-sensitive customers. When this share is sufficiently high, neither firm has an incentive to offer a lower-priced tariff to increase its share of more price-sensitive customers, and the resulting equilibrium is one of higher prices faced by all consumers.

In addition to the proposals above that set out to restrict consumer choice, Ofgem's RMR puts forward the following proposals to increase market transparency.

- **Common pricing**. The requirement for suppliers to offer a single standard evergreen product per payment method would be further tightened through a requirement to standardise the format of these tariffs, with suppliers allowed to compete on a single 'per unit' price.

- **Transfer pricing**. Subject to a review of the existing transfer pricing and hedge accounting practices of the industry, recommendations are to be made on changes to increase the transparency of the existing segmental reporting of the vertically integrated companies with both wholesale and retail activities.

Market transparency is an important factor in reducing search costs and enabling well-informed consumer choices. Ofgem concludes that this can also facilitate competition, by helping to reduce entry barriers as customers find it easier to identify new suppliers with new products and ideas.[15]

However, these benefits should be assessed alongside risks that may accompany the increased transparency of and focus on unit prices, the first of which could be to reduce non-price competition, or quality standards:

> a policy-induced focus on headline price may lead to worse performance on other attributes (such as product quality or small-print charges) ... With increased consumer focus on price, price competition is intensified and lower price-cost margins result. Therefore a firm has reduced incentive to expand its market share by boosting its product quality, and so chooses to offer a lower quality than before.[16]

A key risk from Ofgem's desire to see competition focused on a per-unit price could therefore be reduced quality standards, which in turn might require further intervention to address the subsequent quality concerns. The 'thin end of the wedge' of further regulation could therefore lead to greater price and output regulation.

A second set of problems might also arise. While the headline conclusion of Ofgem's Supply Probe in 2008 was that there was no evidence of an energy market cartel, the subsequent remedies, and those proposed in the RMR, have been to increase transparency, which may act to facilitate coordination.

A further possible consequence of increased transparency is that suppliers may set a standard tariff for all consumers, rather than attempt to price-discriminate through the flexibility remaining to them to offer a range of fixed-term tariffs. Ofgem has suggested that further restrictions could be imposed that would require suppliers to quote prices for all fixed-term products on a basis that is readily comparable to the unit price for their standard evergreen tariffs. The threat of further regulatory scrutiny and intervention to eliminate any perceived discrimination between consumers could therefore further accelerate this, and hinder the effect that price discrimination can intensify competition to the benefit of consumers.[17]

Where next?

Ofgem has identified that a significant number of customers are disengaged from the market, and has put forward well-intended proposals to simplify consumer choice and improve transparency, with the aims of making customers more engaged, improving the competitive constraint provided by customer switching.

The discussion above has highlighted the potential risks and associated costs from introducing contracting constraints, such as those proposed within the RMR. If these risks materialise, Ofgem's intervention may turn out to be counterproductive: market development may be harmed if those consumers who were engaged become less so because there is less choice, and at the same time suppliers face the incentive to remove their most attractive standard tariffs.

As noted by Sir John Vickers, former Chairman of the Office of Fair Trading, policies designed to improve information and decision-making, although not easy, may be less likely to impose distortions:

> the best solutions often involve better consumer information than less consumer and producer choice. But improving consumer information is often easier said than done, especially information that is of immediate and direct practical use – for as consumers we are all boundedly rational[18]

The response of suppliers and customers to the RMR proposals could therefore mark a potentially critical juncture in the performance of the energy supply market, which, if deemed undesirable, could stimulate yet further rounds of regulatory intervention, price and quality control.

Ofgem has highlighted that it will refer the sector to the Competition Commission if it considers that '[the] reforms do not have a realistic chance of addressing the concerns identified due to industry opposition or otherwise.'[19] If Ofgem's proposals are adopted, however, and the adverse effects discussed above materialise, the industry may find itself under such scrutiny as a consequence.

[1] Ofgem (2003), 'Domestic Gas and Electricity Supply Competition. Recent Developments', June, p. 4.
[2] See Ofgem (2005), 'Ofgem's Response to the Super-complaint on Billing Processes made by the Gas and Electricity Consumer Council ("energywatch"). Decision Document', July.
[3] See Ofgem (2008), 'Ofgem Fines nPower for Misselling of Energy', press release, December 22nd.
[4] Ofgem (2009), 'Energy Supply Probe – Proposed Retail Market Remedies', August 7th.
[5] Ofgem (2011), 'The Retail Market Review – Findings and Initial Proposals', March 21st.
[6] Ibid., p. 6.
[7] Vickers, J. (2003), 'Economics for Consumer Policy', British Academy Keynes Lecture.
[8] See Oxera (2011), 'Behavioural Economics in the European Commission: Past, Present and Future', *Agenda*, January.
[9] See Varian, H. (1980), 'A Model of Sales', *American Economic Review*, 70:4, pp. 651–9.
[10] OFT (2010), 'What does Behavioural Economics mean for Competition Policy?', March.
[11] See Armstrong, M. (2008), 'Interactions between Competition and Consumer Policy', OFT Economic Discussion paper.
[12] Ofgem (2011), 'What can Behavioural Economics say about GB Energy Consumers?', p. 15.
[13] Ofgem (2011), 'Supply Companies Failing Consumers: Ofgem Proposes Radical Overhaul', press release, March 21st.
[14] Waddams, C., (2008), 'Response to Ofgem Energy Probe Consultation: December 2008', ESRC Centre for Competition Policy, University of East Anglia, p. 4.
[15] Ofgem (2011), 'The Retail Market Review – Findings and Initial Proposals', March 21st, p. 6.
[16] Armstrong, M. (2008), 'Interactions between Competition and Consumer Policy', OFT Economic Discussion paper, p. 65.
[17] See Armstrong, M. (2006), 'Recent Developments in the Economics of Price Discrimination', in R. Blundell, W.K. Newey, and T. Persson (eds), *Advances in Economics and Econometrics: Theory and Applications, Ninth World Congress*, chapter 4, Cambridge University Press.
[18] Vickers, J. (2003), 'Economics for Consumer Policy', British Academy Keynes Lecture, p. 15.
[19] Ofgem (2011), 'The Retail Market Review – Findings and Initial Proposals', March 21st.

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

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