Why intervention on energy tariffs is needed and how to do it without undermining competition

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No one should be surprised that there are howls of protest and massive lobbying from some of the Big 6 when faced with the prospect of new price caps from the government, to be included as a manifesto commitment. The Standard Variable Tariffs (SVTs) are the profitable bits of their supply businesses and these customers are cross subsidising the switchers. Nor should there be any surprise that some entrants like the high SVTs too: it gives them more profit to go after. No company should be criticised for defending its interests.

The companies have been through the lengthy Competition and Markets Authority (CMA) inquiry, and the CMA in turn has proposed its solutions to the detriments it identified. As I argued in an earlier paper (*The CMA Energy Market Investigation - Companies 5-0.* 15th March 2016[1]), the companies ran rings around the CMA. The quality of the CMA Report was widely believed to be poor.

Yet the howls have gone too far – and may in the end damage the companies themselves. It is claimed that intervention will damage consumers, and that it will undermine competition. These are easy assertions to make, and they can easily be proved provided a sufficiently ill-designed form of intervention is imposed. Setting up an interventionist straw man, and then shooting it down is not hard.

The facts – and the options – are rather more subtle, and require a much more serious assessment. This is not just a rampant bout of populism. Both major parties have got to the point of thinking intervention is needed. In a democracy this sort of consensus should give pause for thought. The CMA thought

[1] http://www.dieterhelm.co.uk/energy/energy/the-cma-energy-market-investigation-companies-5-0-cma/

intervention was necessary in the pre-payment meter customer class, and the big detriment for the rest of the SVT customers would not go away of its own accord, even if its majority report solution has little chance of working. Martin Cave dissented – he thought all the SVT customers should be protected, since he did not think the majority CMA remedies would do the job. I agree with Martin, though not with the form of his proposed intervention. The 60-70% of non-switchers include lots of people for whom the premiums they are paying are very painful. We are not populists and our arguments are not based on some crude populist appeal. These are real detriments with real economic consequences on customers.

There are several core features of this market that are either confused or ignored by the lobbying. They include:

(i) The SVTs have not followed the only main market variable cost – the wholesale price. For over 3 years this fell (overall substantively), and the SVTs were not cut. All sorts of spurious arguments were mounted to explain this. When the wholesale price was falling, one prominent chief executive explained that prices to customers could not be cut, because the companies had bought and hedged ahead (at higher prices). The converse logic was strangely absent when the wholesale price went up.

(ii) The rise in the government-driven levies and other fixed costs do not exactly match the falls in the wholesale prices. There is indeed no neat correlation to explain away the failure to pass on wholesale price falls to customers. The facts were pretty clear when Ed Miliband first pointed to these market failures, and induced the then Coalition Government to reach for the CMA to head off Miliband.

(iii) The share of the variable wholesale prices in the total cost of electricity is falling. In a world of zero marginal cost renewables, and increased reliance on fixed Feed-in-Tariffs, capacity contracts and other levies, the suppliers are increasingly "levy collectors" (or in some cases tax collectors). Add in the collection of transmission and distribution costs, and the result is that the companies are meter readers, bill collectors, and the variable bit is getting ever smaller. Eventually, as I argue in my new latest book, *Burn Out – the endgame for the fossil fuels*[2] – the wholesale market will largely wither away. The economics of supply are gradually migrating to the economics of broadband – a capacity not an energy market.

(iv) Since all customers – SVT or not – have to pay the increasing share of fixed costs, the competition is about the declining residual wholesale costs and the efficiency of the customer servicing businesses. Yet the companies have a very poor record of hedging the wholesale prices (see above for example when wholesale prices fell) and in aggregate probably do not do better than a simple index of the market price. Yet they do not offer this index as part of the SVT.

(v) The frequent interventions, fines and restraints the regulator has applied to the supply companies also point to some aspects in some companies of very poor management. Despite this the worst of these still retain a lot of SVT customers.

(vi) The CMA's belief that the SVT problems would largely go away when smart meters are universally available depends upon the idea that the competition that the meters are engendering is all about the variable wholesale prices. But these, as noted above, are withering away slowly. The smart meters are a possible answer to a question that is less and less important. Their real value is to the system as a whole and the system operator, as I argue in my recent paper on smart meters (*Not so smart – what has gone wrong with the smart meter programme and how to fix it.* 24th March 2017[3]). All this assumes of course that smart meters are being efficiently installed to the 2020 timetable and that they actually enable customers to switch. (Incredibly, there is some evidence that they do not even achieve this!)

[2] For more information on Burn Out: http://yalebooks.co.uk/display.asp?k=9780300225624

[3] http://www.dieterhelm.co.uk/energy/energy/not-so-smart-what-has-gone-wrong-with-the-smart-meter-programme-and-how-to-fix-it/

(vii) The overall detriment that the CMA identified is not trivial and has not gone away. It was large – very large.

The economics of supply are pretty simple – unsurprisingly since selling homogenous products, electricity and gas, to customers is a pretty simple business. It is not rocket science. The cost of electricity is:

> *The wholesale price + the FiTs + the capacity contracts + the transmission system costs + the distribution costs + the margin for billing, metering and customer services*.

There is a very surprising further fact: no supplier offers a transparent tariff along these lines. The mark of a competitive market and a competitive price is that it mirrors the underlying costs of an efficient supplier. This market doesn't do that.

Why not? The possible reasons are: the suppliers can do better; or they can get away with charging more, because they have an element of market power. There is no evidence that they are better at hedging the wholesale costs, so it has to be the second. That is what the CMA rightly concluded.

Indeed, if the tariff mirrored these cost items identified above, then the SVT customers would really have competition to benefit from. For the only way to better the offer of rivals would be to offer a lower margin, since the margin reflects the only costs the managers do actually control. This would bear down on the efficiency and competence of the supply businesses. Contrary to the claims that intervention would undermine competition, if it were to require the above tariff in the new SVT, then the customers would be a lot better off.

My proposal is that this tariff should be the *default tariff* (first set out in *Penalty tariffs, open-ended regulation and embedding overcharging - a critique of the CMA* *provisional finding and remedies* July 2015[4]), and that suppliers would remain free to offer any other tariff. They would have to publish the details of this default tariff, so customers could see the different elements, and they would especially be required to publish their margins. The reason is obvious: the margin is the only thing that the companies really control and manage. Nobody can object to making this information – and indeed the costs of all the bits – transparent.

What would this tariff reveal? Embarrassingly it would reveal that there is a wide range of margins, partly reflecting different levels of efficiency (and inefficiency) and party reflecting the segmentation of the market and the extraction of premiums from different groups on non-switchers.

Switching between suppliers each offering this new default SVT would be much easier: the customer only needs to look at the only variable element – the margin. It would be best if the margins were listed up on OFGEM's website for all to see. If one company takes say 8% margin for supplying gas or electricity and another 1%, this is all that customers need to know. All the fancy "special deals", "fixes" etc. just wither away – unless some company wants to offer a fixed margin for a few years. There would be nothing to stop the companies still making these complex offers, but it is hard to see where the upside would be.

Better still, it is the margin where the competitive market has the most chance to impact. Lots of new suppliers, focussing on the household broadband hubs and broader services, could sell multiple services – not just electricity and gas, but communications, films and even groceries. Think of the margin an Amazon might require? This indeed is what happened in retail petrol: the supermarkets came in and offered petrol and everything else at the supermarket, and as a result they offered the lowest petrol margins and prices. This is the sort of technical revolution that broadband brings. Imagine a world where the margin is not 8%

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[4] http://www.dieterhelm.co.uk/energy/energy/penalty-tariffs-open-ended-regulation-and-embedding-overcharging/

or 4%, but 0.1%. In a few years' time just selling electricity and gas may seem pretty quaint. Some of the new entrants are already offering multiple services.

This default tariff would revolutionise competition, *but only if the margin is unregulated*. Here the companies have a very good point. A crude price cap might relieve the excess returns that the CMA identified, and since competition is a means and not an end, putting an end to the exploitation of the old, the ignorant or those who have got better things to do than spend their evenings trying to understand the complexity the CMA wants to encourage is a worthy aim in its own right. The fact that the share prices have taken a hit is a reflection of the fact that a price cap would cut away at the margins. But it is not necessary.

It is important to remember that there always is and will be a default tariff, even if as some companies would like, customers are forced to choose. In a context in which the public is widely sceptical of the conduct of the companies and believes (in my view rightly) that the market is not functioning well, simplicity is a critical necessary condition to rebuilding trust. Simplicity works best with transparency.

The best solution is therefore to impose a regulated *form* of the default tariff, which is available to all – not a price cap. It is:

> ***Indexed wholesale price + fixed cost pass throughs + unregulated published margins***

There are two further objections that have been raised. The first is to ask: "which index?" and to question the error corrections. This is a technical issue, and it is perfectly straightforward to solve. The second is to argue that this simple transparent tariff would kill competition because everyone would want to be on it. In other words, it would be too successful.

In this second claim, the critics are right. But what exactly is bad about the bulk of the customers migrating to the default tariff? Indeed doesn't this make the market intensively competitive and focus around the costs that the companies control – the margins? Isn't that exactly what a competitive market should do? Shouldn't there be an intense market to offer competitive default tariffs? Isn't this the best allocation of resources?

The huge head of steam this issue is generating polarises both sides. It sets the argument between those who think the current state of play is fair and reasonable and working well, and the other side that just wants to regulate the price (and indeed Miliband advocated at the 2010 election). The former just doesn't stand up against the evidence. The latter is not a good idea, in that the state is already back through the single buyer in determining all new investment in electricity, and hence doing already much of what the CEGB once did, and full supply price regulation is the last main step to complete the U-turn.

It is here I depart from Martin Cave's recommended solution. The default tariff I propose meets the concerns of exploitation of customers and – at the same time - those of competition. It stops the exploitation dead in its tracks, whilst encouraging and greatly enhancing competition from new entrants around a clear and published margin. It is the best way to get to the broadband-driven multiple household supplier models, where margins fall back sharply. Now that really would be bad news of the incumbents. But that is what competition could deliver, the competition the Big 6 and many of the entrants shout so loudly in favour of. They should perhaps be careful of what they wish for.