REGULATORY INSIGHT

RETAIL ENERGY

9 June 2017

Implications of widening GB energy retail price controls

The result of the UK election undoubtedly creates a period of political instability, but manifesto promises by both the Conservative and Labour parties mean that the introduction of a cap on energy prices remains firmly on the agenda. This potentially threatens previous efforts to encourage retail competition and raises critical issues around how a cap could be effectively implemented.

Summary

The Competition and Markets Authority's (CMA's) recent Energy Market Investigation found that the majority of customers did not effectively engage in GB's retail energy markets to achieve significant potential savings through switching tariffs, suppliers and/or payment methods. With those on prepayment meters facing "particularly high" detriment, the CMA proposed to cap prices for those customers. However, given the significant risks associated with price caps, the CMA proposed alternative remedies in order to strengthen market signals to, and encourage wider engagement by, other customers. At the same time, Ofgem has been moving from a prescriptive approach to a more principles-based approach to regulation. Seemingly flying in the face of these efforts, both of the main political parties pledged to impose a cap on energy prices (albeit in slightly different forms). With little known about the precise structure of the proposed caps, there are concerns about how they would be implemented and whether they would deliver the parties' visions of fair or secure, affordable and sustainable energy markets.

Implications of widening GB energy retail price controls

During their election campaign, the Conservatives pledged to extend the retail energy prepayment price cap introduced by the Competition and Markets Authority (CMA) to protect vulnerable, constrained consumers to all domestic consumers on suppliers' default standard variable tariffs (SVTs). In its manifesto, Labour pledged to impose an emergency price cap to "ensure" that the average dual-fuel household energy bill remains below £1,000 per year. Price caps tend to be, for good reasons, a policy of last resort. Regardless of the final form of the future government, policy makers and the regulator will need to consider how a cap should be implemented if it is considered a sufficiently important policy objective to take forward.

Widening energy retail price controls

Some 16% of customers are on prepayment meters and there is a strong correlation between prepayment customers and characteristics associated with vulnerability, such as low income and education levels, as well as disability. Having found that prepayment customers were less engaged than other customers; that suppliers were less incentivised to engage with them; and that potential savings of up to £370 could be available to dual-fuel prepayment customers if they were to engage with the market, the CMA felt it was imperative to intervene. It proposed a temporary price cap covering the period to 2020 (to be recalculated every six months), which Ofgem implemented in April 2017 using the CMA's cost-reflective calculations.

The CMA rejected (by a majority) proposals to extend the price cap to all SVT customers (including dual-fuel), arguing that such a move risked undermining the competitive process, reducing the incentive of customers to engage and increasing regulatory risk – it felt that it was more appropriate to strengthen competitive market forces through other measures. Despite the CMA's findings, the Conservatives want to extend the existing price cap approach to all SVT consumers (who account for about 70% of the Big Six's customer base). Labour's proposals would apply to 20 million dual-fuel customers (over 70% of the electricity retail supply market; almost 90% of the gas market).

Contrary to market based policy

The proposals to cap prices have been met with surprise and concern, especially as they appear to contradict key findings of the CMA investigation. In particular, the CMA found there was not a clear enough distinction between the government and the regulator to enable effective regulation of the sector. The CMA recommended establishing clear boundaries by defining the role of the government as creator of the regulatory framework, with the regulator's role to independently decide how to implement that framework. However, both parties' proposals effectively dictate that Ofgem will fulfil its duty to protect consumers by introducing a price cap, leaving little, if any, discretion for Ofgem to consider alternative options.

Moreover, Ofgem has recently been placing greater emphasis on pursuing a principles-based approach to regulation (as opposed to a prescriptive approach), focusing on strengthening competition and encouraging consumer engagement. With the CMA finding that a substantial proportion of the detriment identified resulted from disengaged consumers, Ofgem's approach was expected to provide an additional tool to help support a long-term solution. However, this could be undermined if consumers see less need to engage with the market because they feel that the government is watching out for them. In addition, if tariffs trend towards the price cap there will be less distinction between suppliers and tariffs, further reducing the advantage of engaging, and hence their incentive to switch. Broadening the price cap could, therefore, discourage consumers from actively providing the competitive demand-side pressures required to incentivise suppliers to compete for their business.

Challenging to establish appropriate parameters

There are also significant concerns about the setting of a price cap, especially as it will be incredibly difficult for Ofgem to establish the appropriate price cap level because of the asymmetry of information in favour of the supplier. If the cap is set too high, there is potential for consumers to be worse off than under competitive market conditions. If the cap is set too low it may negatively impact companies' viability, ultimately leading them to exit the market and, thereby, reduce choice for consumers. Furthermore, and reflecting a trend that already appears to have started, suppliers could remove their cheapest tariffs in order to hedge against the cap being set too low. This means that even if the cap reduces the maximum price charged, it will result in higher average prices for all consumers. Effectively, those consumers who engage with the market may be penalised by higher tariffs as a result of measures to protect a different, albeit substantially larger, group.

However, depending on a new government's priorities, it may no longer be a question of whether to introduce a price cap but how it should be implemented. There are a number of factors to be considered. For example, the cap will need to be cost reflective to enable the retail market to operate effectively. It will need to be dynamic (e.g. adjusted every six months or so) to reflect the variability in the underlying costs, such as wholesale energy prices, network tariffs, and social and policy costs, some of which are rising in any case. In addition, it needs to be clearly communicated to customers that the price cap will not stop prices from rising if the underlying costs increase; and that there will still be savings available from engaging with the market.

Still need to consider the long run

Finally, it is important that any price cap is only introduced as a short term measure with clearly defined objectives and parameters, and be regularly reviewed against those objectives. For example, the CMA's prepayment price cap only applies to 2020 when the rollout of smart meters is expected to be completed. This measure is aimed at protecting 'sticky' consumers until better information and tools become available to facilitate their engagement with the market. Moreover, by providing real-time feedback on consumption and the associated costs, smart meters should address a number of barriers to engagement with the market. Smart meters are also expected to facilitate faster switching, the introduction of time of use tariffs, and automated demand side response which, combined with the introduction of new business models, should make it easier and more rewarding for energy consumers to engage with the market.

The focus of the two parties on affordability must also be considered against the other elements of the trilemma, namely sustainability and security of supply. Prices provide a vital signal to consumers to conserve energy, which helps reduce capacity requirements for safe operation of the energy system and manage intermittency in renewable generation. By making prices less flexible, a cap reduces the strength of the incentive for behavioural change.

It is also vital that the overarching focus of policy remains building consumers' confidence and ability to engage with the retail energy market. With energy systems becoming more flexible and distributed, consumers need to be empowered to engage with these increasingly complex markets to maximise their benefits. This is the focus of a number of the CMA's remedies, as well as one of Ofgem's stated objectives. However, the extent to which Ofgem can pursue its objectives is constrained by the energy policy framework. If politicians continue to dictate specific requirements, it will significantly limit Ofgem's ability to implement the inventive and flexible regulatory approaches required. It will also limit the industry's ability to innovate.

How can we help?

IPA Advisory is well placed to advise clients on the implications of policy and regulatory developments across the full energy value chain in UK and EU energy markets. We have extensive expertise creating tailored, informed insight into policy and regulatory developments for a range of clients, including international institutions, energy ministries and government departments, sector regulators and competition authorities, market participants, investors and financiers.

We are intimately familiar with the dynamics of UK energy markets. Our staff have deep industry, policy, and regulatory expertise with extensive experience combining policy and regulatory risk analysis, mitigation strategy development, and expert energy system modelling. We have substantial experience in contributing to the development of policies and regulations, communicating these policies and regulations to stakeholders, and providing invaluable insight into different approaches to regulation. Our strong understanding of the analysis and strategic thinking required to develop and conduct price controls includes estimating capital structures and costs, as well as ensuring the analysis reflects the financing required for companies to sustainably and effectively deliver and maintain quality service for their consumers.

What relevant services have we provided recently?

- Computing the distributional impact of time of use tariffs enabled by the smart meter rollout, exploring opportunities for mitigating adverse impacts, and assessing international experience to inform consideration of potential policy gaps;
- Elucidating the requirements for independence of a National Regulatory Authority;
- Critically assessing retail energy companies' cost data to support an EU National Regulatory Authority, including identifying trends, comparing relative performance, and flagging issues;
- Establishing a methodology to benchmark the competitiveness of retail energy markets in the EU 28 and Norway for the Agency for the Cooperation of Energy Regulators, including price dispersion and consumer switching, to inform their market monitoring; and
- Calculating the appropriate weighted average cost of capital for a vertically integrated energy company, as well as the underlying businesses, to support a regulator through a price control.

Who have we recently worked with?

- Office of Gas and Electricity Markets
- Department of Energy and Climate Change (now the Department for Business, Energy and Industrial Strategy)
- Agency for the Cooperation of Energy Regulators
- Danish Ministries of Finance and Energy

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