



CMA Energy Market
Investigation: Proposed
remedies

Introduction

This paper accompanies OVO Energy's response to the CMA Updated Issues Statement (Ovo UIS)¹. The purpose of this paper is to describe our view of the necessary remedies to address the problems in the energy retail market. The aim is a market characterised by innovation, pressure to improve efficiency, good customer service and reasonable prices for all customers. The current market often fails against these criteria.

Problems in the energy retail market

In our response to the Updated Issues Statement, we argued that the major problems in the energy supply market are:

LEGACY CUSTOMER BASES AND SEGMENTATION OF 'STICKY CUSTOMERS'

1. Incumbent suppliers are able to use their large base of inactive, inherited customers to segment the retail market. This has a detrimental effect on customers and competition in the market.
2. The effect of the segmentation of this large block of inactive customers by incumbent suppliers has been to create two retail markets. One (much smaller in size) is competitive, comprising of active switchers putting downward pressure on costs. The second is passive, comprising of loyal customers stuck on high standard variable tariffs. The second group is more likely to include the poorest and most vulnerable customers.
3. The target is a competitive market with reasonable prices for all customers, however when considering remedies it is important to note different characteristics and behaviour of customers who are unable or less able to engage in the market (because of their social or financial circumstances), from those who are well placed to engage but choose not to for various reasons. Our analysis suggests these different customer groups require different remedies, both those which will improve things for the majority of UK customers, and also those targeting areas where the problems are most severe.
4. Evidence from the UIS appears to show that average Big Six Standard Variable Tariffs (SVT) are moving away from underlying costs. This suggests that SVT prices do not seem to be responding to competitive pressures. Incumbent

¹ Ovo (2015) Response to the CMA Updated Issues Statement [available here](#)

suppliers appear not to be charging a fair price based on cost to serve, as you would expect in a competitive market.

5. There are many reasons why UK customers rarely, if ever, switch energy supplier. Loyalty (misplaced or otherwise) of large groups of customers in a market can insulate incumbent players against normal competitive pressures, leading to worsening customer service, little downward pressure on costs, and few efforts to innovate. These are all evident in the GB supply market.
6. The existence of inactive customers does not always imply harm to competition in a market. However, we argue it does in the energy supply market. This is not only because of the prejudicial approach incumbent players take to this customer group, but also because these are largely inherited or 'legacy' customers.

CROSS SUBSIDISATION AND LOSS-LEADERS

7. The ability to gain high returns from SVT customers has allowed the Big Six to cross-subsidise protective tariffs that have hampered the emergence of a diverse, thriving competitive supply market which would drive cost reductions, improvements in customer service, and innovation. We think there is evidence that some of these tariffs have been loss-leading. This is the biggest barrier to expansion for new, innovative, efficient entrants. Regulatory intervention has not stopped this.
8. The existence of these tariffs prevents innovative firms with higher standards of customer service from exploiting profitable opportunities in the market. When these tariffs disappeared from the market for a 12-month period, the share of switches to independents like OVO, with a lower cost base, grew considerably.
9. This problem of incumbency has been made worse by poor regulatory and policy interventions. There is too much regulation in the energy sector, which acts as a barrier to entry, expansion and innovation, either in new products or customer engagement. We think much of the regulatory intervention, in particular the Retail Market Review rules, has damaged competition and stifled innovation in a sector which should be leading on technology development, behavioural change and sustainability.

What should the energy market look like?

10. The remedies we propose in this paper aim to harness the benefits of a liberalised, competitive market. Competition has driven efficiencies, particularly in the generation sector. The wholesale market generally works well. In a small part of the retail market there is cut-throat price competition. And in recent years, there has also been entry and growth by new suppliers, often offering greater product innovation and better customer service.

11. However, the current structure of the supply market and the overly-complex rules that govern it have not driven innovation and improved customer service in the way it should, either in comparison to other retail markets; or to other energy supply markets around the world. There has been little downward pressure on costs for incumbent suppliers, little innovation and worsening service for customers. Crucially, the structure of the market has limited opportunities for new, innovative entrants to exploit profitable opportunities.
12. Any proposed remedies must simplify regulation in order to encourage innovation. There are likely to be huge changes in the way the energy retail market works in the next 10 years, driven by digital and smart technology. These are likely to drive dramatic innovation in products, services and customer experience. If taken advantage of, these changes could yield significant benefits for customers; reducing the overall cost of the energy system, making it more sustainable, and keeping downward pressure on bills.
13. However, the current market rules, in particular RMR, risk preventing such a transformation. The industry must establish a regulatory regime that encourages, rather than stifles, innovation, while ensuring that suppliers think hard about how to treat customers fairly on both price and service.
14. Energy is an essential service. It is hard to take a useful part in society without access to affordable gas and electricity. Currently, the most vulnerable are less likely to benefit from competition. Interventions to address this problem have had limited effects. The market's structure should offer further specific protections for the most vulnerable customers. Such changes will also limit the ability of the incumbent suppliers to charge high prices to loyal, often vulnerable customers; tariffs which fund anti-competitive, loss-leading tariffs. In the medium term, suppliers will have to innovate, not loss-lead, to compete. This will lead bills that are as low as possible for all consumers.

Proposed Remedies

1. PRINCIPLES-BASED REGULATION

15. The quantity and complexity of regulation in the energy retail market is a barrier to entry and expansion for independent suppliers. In recent years, these rules have become ever-more detailed and prescriptive. In particular, changes under the Retail Market Review (RMR), have stifled innovation from new suppliers. Much of this should be stripped away, in particular the draconian 'four-tariff rule', which has had a chilling effect on innovation and customer engagement.
16. A move towards principles-based regulation, focused on overall priority of 'avoiding customer harm', would force suppliers to consider the best interests of customers in any decision they make -rather than simply reacting to detailed rules about what piece of information should go on which part of the bills. Ofgem's current Standards of Conduct (see Box 1) provide a good starting place

for a principles-based review of the energy market². Decisions in recent years also provide a strong body of case-law which could guide enforcement action in the future.

17. Good regulation is a prerequisite for a functioning energy market. Where all participants know and understand the rules, and they are well enforced, competition and innovation can flourish. However, much of the existing regulation is overly complex, nonsensical and burdensome to the point of inhibiting entry and expansion. This approach is ripe for an overhaul based on simplicity underpinned by strong, clear, practical principles.
18. However the success of such a principles-based approach is dependent on a regulator who is willing and able to give swift and meaningful punishment for poor behaviour.
19. Such a review of the current regulatory regime must also include a review of how Industry Code changes are decided upon. Pro-competitive measures such as cash-out reform, Project Nexus, half-hourly settlement and faster switching are often mired in committees that take years to come to decisions. This cumbersome process is also damaging to competition, as the sheer volume and obscurity of the code process effectively excludes independents from the regulatory development process without huge investment in expertise, meaning the committees of decision makers are largely comprised of incumbents with little vested interest in changing the status quo.
20. We therefore propose:
 - a. A rigorous, wholesale review of all regulation. In particular, the four tariff restriction under RMR and the accompanying rules.
 - b. Move towards a system of principles-based regulation based on the Standards of Conduct.
 - c. A review of how Industry Codes are decided, making the process as open, transparent and fair as possible.

² It is unfortunate (and odd) that the broad Standards of Conduct were introduced at the same time as the detailed, prescriptive rules of RMR.

BOX 1. OFGEM STANDARDS OF CONDUCT

BEHAVIOUR: suppliers must behave and carry out any actions in a fair, honest, transparent, appropriate and professional manner.

INFORMATION. Suppliers must provide information (whether in writing or orally) which is:

- Complete, accurate and not misleading (in terms of the information provided or omitted);
- Communicated in plain and intelligible language;
- Relates to products or services that are appropriate to the customer to whom it is directed; and
- Fair both in terms of its content and in terms of how it is presented (with more important information being given appropriate prominence).

PROCESS. The supplier must:

- Make it easy for the consumer to contact them;
- Act promptly and courteously to put things right when they make a mistake; and
- Otherwise ensure that customer service arrangements and processes are complete, thorough, fit for purpose and transparent.

2. INTRODUCE A REGULATED SOCIAL TARIFF FOR ALL SUPPLIERS

21. Political attention and the CMA's Updated Issues Statement have rightly focused on the disproportionate number of vulnerable customers who are losing out in the current energy market. Regulatory interventions have failed to overcome this (and in the case of restrictive rules around direct selling, may have harmed it). Any proposed remedies that fail to address this longstanding mistreatment of the most vulnerable customers, are unlikely to relieve the political pressure on the energy industry. Clear protection for the most vulnerable consumers is long overdue.

22. We have considered various options for tariffs to protect the most vulnerable households including an Ofgem-set social tariff, a social tariff set at a set discount to the SVT and a social tariff set at the level of the cheapest tariff supplier. Our modelling and analysis is described in detail later in the paper. Following that analysis, our proposed remedy is a social tariff set by Ofgem. The tariff would have the following characteristics:

- Ofgem should set a regulated social tariff every year to specifically protect the most vulnerable customers. This will consist of a fixed standing charge and unit rate, and will last for 12 months. The social tariff price that Ofgem set would represent a price ceiling for all social

tariffs offered in the market. Suppliers could therefore continue to compete below the Ofgem set price.

- Government will have responsibility for establishing which groups of customers are eligible for the social tariff. Previous social tariff schemes have relied on suppliers to categorise and identify vulnerability. These are political, not market decisions and suppliers are not well-placed to make them. We explore different options to identify eligible customers later in the paper. It is likely that around 2-3 million households would benefit.
- Government should provide suppliers with a list of relevant households, as it does currently for part of the Warm Home Discount (WHD). Without this clear list, implementing such a scheme will be extremely difficult.
- All of a supplier's social tariff customers must be auto-enrolled on a social tariff, unless the current deal the customer is on is cheaper.
- Social tariff customers may switch to cheaper tariffs. However social tariff customers will automatically revert back to their supplier's social tariff if the cheaper tariff should expire.
- To ensure that suppliers do not try to actively avoid social tariff customers, Government should run a reconciliation process to ensure that suppliers contribute an amount proportionate to their market shares. Such a system already exists with the WHD Core Group.

Our analysis suggests that social tariff customers moving from a high Standard Variable Tariff (SVT) would get a cheaper price for their energy. This could be around £160, depending on at what level Ofgem sets the tariff. Such customers would also benefit from the stability and transparency that such a tariff would offer, allowing them to plan accordingly. They will also have confidence that they are not being discriminated against by their supplier because they are less likely to switch.

These customers would still have an incentive to engage in the market as there would likely still be some cheaper deals available, particularly from suppliers with lower costs.

The policy will also have the important secondary benefit of reducing the pool of inactive customers the incumbents are able to overcharge. This will reduce the incumbent suppliers' ability to use these loyal customers to cross-subsidise loss-leading tariffs, which have been so damaging to competition. Our analysis suggests that the average difference between the Big Six SVT and the average Big Six cheap tariff would reduce from £153 to £94 (of course, for some suppliers with very high differentials, this reduction would likely be greater). This means that suppliers will have to innovate and cut costs in order to compete on price.

3. INTRODUCTION OF COST-REFLECTIVE PRICING PRINCIPLE

While the two measures above would encourage innovation and protect the vulnerable, it is not certain they would eliminate one of the main problems in the energy supply market: the ability of incumbent suppliers to overcharge loyal customers and use these funds to offer loss-leading tariffs. These tariffs have returned to the market in the past year. They have one of the most serious adverse effects on competition in the market.

While removing the most vulnerable customers from the market will reduce the ability of the incumbent suppliers to do this, it will likely not remove it. Our modelling suggests that just a £50 increase in the price of the average SVT allows suppliers the ability to offer loss-leaders at a £300 discount to their SVT, while retaining the same level of profitability. Also, there is a risk that by giving social tariff customers specific protection, it could give the impression that regulators would allow an even more extreme 'free-for-all' in the unregulated part of the market, with even higher differentials between SVTs and cheap fixed tariffs. Such an outcome, which is already a major problem in the current market, would not be desirable for the majority of energy customers.

Ofgem should therefore also introduce a regulatory principle of cost-reflectivity in supplier tariff pricing, as part of its wider introduction of principles-based regulation. This would aim to prevent suppliers from engaging in either loss-leading or overcharging.

As our response to the UIS showed, the price differentials between some suppliers' cheapest tariffs and their expensive SVTs is very high³. It is not clear they can be explained by differences in cost to serve. Under the proposed principle:

- a) Suppliers must be able to justify shorter-term, deeply discounted tariffs on a costs basis. At present, it is not clear how the large differentials between Big Six SVT and the deep-discounted tariffs can be justified.
- b) Ofgem should be able to ask a supplier to justify such discounting at any time. As with all principle-based regulation, it is important that such a principle is backed up with strong regulatory powers to punish transgressors, and a regulator who is determined to act swiftly and aggressively.
- c) This would mean quick and significant fines, banning from marketing tariffs for a period of time or losing their supply licence if they breached the principle. It is worth noting that for persistent failures of customer service, one of the Big Six suppliers was prevented from telesales for just

³ Ovo UIS Response (2015), provided evidence that the maximum difference was £248.45 including online discounts.

12 days⁴. This appears likely too limited in scope to act as a real disincentive.

- d) At the same time, Ofgem should be able to scrutinise and challenge apparently high-cost SVTs. As we have seen in recent years, significant drops in the wholesale electricity and gas prices have not translated into cheaper SVTs for Big Six customers. Such anomalies should do real customer harm and should be ended.

In the Netherlands, the regulator has the statutory power to make sure prices charged to consumers are 'reasonable'⁵. The Dutch enforces this by having to pre-approve any new tariffs. We think this would be a step too far, and would likely stifle innovation and nimble action by energy suppliers. However, the clear principle is the right one.

We believe these three changes will help deliver a more competitive market, where there is strong pressure to improve efficiency, innovate and improve customer service. We also think it will deliver a fairer price for all customers.

Analysis of social tariff options

The aim of any reforms should be to ensure the maximum benefits of innovation and efficiency provided by a liberalised energy market, whilst ensuring all members of society have access to an affordable supply of electricity and gas.

While there have been significant benefits to competition in the liberalised UK energy market, some customers have become effectively stranded from the market. This is not surprising and is evident in many different markets outside of energy. However, energy is "an essential service"⁶, and therefore different from, for example, broadband or mobile phones. Considerable evidence⁷ suggests that poorer and more vulnerable customers appear less able to engage in the market. This is not acceptable. Moreover, and as our UIS response argues⁸, there is also evidence that

⁴ Ofgem (2015) Press Release: Scottish Power accepts sales ban after failing Ofgem's customer service target 4th March 2015

⁵ IEA (2008) 'Energy Policies of IEA Countries: The Netherlands'. Available [here](#)

⁶ Nolan, D. (2015) Ofgem Presentation; Energy: Competition and Regulation, February.

⁷ from Ofcom in addition to the CMA

Ofcom decision-making survey carried out by Saville Rossiter-Base in July to August 2009, June to July 2011, July to August 2013

GfK NOP Energy Market Investigation A report for the Competition and Markets Authority 2015

⁸ Ovo (2015) Response to the CMA Updated Issues Statement. Available [here](#)

the existence of a large group of disengaged customers among the incumbent Big Six suppliers is damaging competition. This also needs to be addressed.

The current retail energy market is effectively split in two. One is competitive, comprising of active switchers putting downward pressure on costs. The second is passive, comprising of customers stuck on high standard variable tariffs. The second group is more likely to include poorer and vulnerable customers. We believe it is important to distinguish between customers who are stranded, unable to take advantage of the benefits of the market because of their social or financial circumstances, from those who are well placed to engage but do not, for whatever reason.

There have been repeated efforts by Ofgem in recent years to encourage switching, including efforts targeted at the most vulnerable customers. Much of this has focused on providing more detailed and richer information on bills and trying to 'simplify' the market. While this has been well-intentioned, as are efforts to make it easier to switch suppliers, it is not clear this has substantially improved the retail market on the scale required to ensure effective and fair competition.

It would be more honest to concede that a large group of customers will simply not engage in the energy market, and that the most vulnerable among these should be protected. Once that intellectual leap has been made, potential remedies are more straightforward.

The below section looks in detail at the potential remedies to protect poorer customers, and considers different options.

Options for different social tariffs

Different energy markets have attempted different types of tariff structures to protect consumers whilst endeavouring to maintain competition. These include a 'price to beat' mechanism in Texas⁹, social tariffs in Belgium¹⁰ and regulated tariffs as seen in Northern Ireland. These have different advantages and disadvantages, and it is worth stressing that any proposal will not solve all of the problems of a market and will likely create some negative features. For example the price to beat scheme in Texas was successful at improving switching rates, yet customers who left the incumbent supplier ended up paying considerably more for their energy in the medium term¹¹. Other initiatives may not be suitable to the circumstances of the UK market or UK economy. The social tariff scheme in Belgium is designed solely to

⁹ Texas Coalition for Affordable Power (2014) Deregulated electricity in Texas; A history of retail competition

¹⁰ OECD (2013) Belgium: Inventory of estimated budgetary support and tax expenditures for fossil fuels

¹¹ Texas Coalition for Affordable Power (2014) Deregulated electricity in Texas; A history of retail competition

protect vulnerable customers, but it is funded by the Government. Such a scheme is unlikely in the current UK fiscal context.

The UK has used various types of social tariff and similar measures to protect vulnerable customers in the past (see Box 2). Current schemes include the Warm Home Discount¹² and the Cold Weather Payment¹³. However, it is not clear that the current schemes are having the full desired effect. For example, a customer on the average Big Six SVT is paying £1,159 a year. Even with the WHD, the customer on average consumption is paying, £1,019 or £101 more than the cheapest deal in the market¹⁴. Such a payment would go further if the customer was already on a lower tariff.

OPTIONS

In this paper, we consider three broad options for a social tariff:

- A social tariff set by Ofgem at a fixed rate for a year.
- A social tariff, set at a level based on a fixed discount from a suppliers' SVT.
- A social tariff priced at a level equal to a supplier's cheapest available tariff.

We have then modelled the impact of the three different options on the wider market, particularly the prices of the Big Six incumbent suppliers.

¹² The Warm Home Discount scheme is a rebate paid to eligible energy customers via a discount on their energy bill. The current discount amount is £140.

¹³ The Cold Weather Payment is a social welfare payment made to eligible individuals during periods of very cold weather. The current payment amount is £25 per week of weather where the temperature fails to exceed 0 degrees Celsius.

¹⁴ Cheapest deal in the market on 3/3/15 was Scottish Power Fixed Tariff

Advantages and Disadvantages

	DESCRIPTION	ADVANTAGES	DISADVANTAGES
OFGEM SOCIAL TARIFF	Ofgem sets a social tariff price all suppliers must price below.	<p><i>Transparent</i> - price set by Ofgem</p> <p><i>Price Certainty</i> - price is fixed each year</p> <p><i>Pro Competition</i> – suppliers can still offer social tariffs that are cheaper than Ofgem price. Customers can also switch to non-social cheap tariffs</p>	<i>Increased Regulation</i> – Ofgem would be required to administer the price of the social tariff
SVT DISCOUNT SOCIAL TARIFF	Suppliers must offer eligible customers a social tariff set at a fixed discount from their SVT. Ofgem would set the level of discount.	<p><i>Simple to administer</i> - Ofgem would decide on a discount price to apply to all suppliers</p> <p><i>Transparent</i> – Vulnerable customers save a minimum of the discount amount</p> <p><i>Pro Competition</i> –suppliers would be free to offer a further discount on their SVT price</p>	<p><i>Increased regulation</i> – Ofgem would be required to set the differential</p> <p><i>Price Uncertainty</i> - Social tariff prices could vary significantly between suppliers as SVT prices are not all the same. Social tariff prices would also change as SVT prices change</p> <p><i>May not protect vulnerable</i> - Suppliers may choose to have high SVT and social tariffs</p>
SOCIAL TARIFF = CHEAPEST TARIFF	Social tariff price is equal to the price of a supplier's cheapest tariff.	<p><i>Simple to administer</i> – Suppliers would simply transfer vulnerable customers to their cheapest tariff</p> <p><i>Simple to regulate</i> – would not require Ofgem to set tariff or differential.</p> <p><i>Transparent</i> – vulnerable customers would know they were on the cheapest tariff available with their supplier</p> <p><i>Competitive pressure on costs</i> - Social tariff prices would be linked to the cheapest tariff market which has been more competitive than the SVT market</p>	<p><i>Price Uncertainty</i> - Cheap tariff prices change frequently and vary significantly between suppliers</p> <p><i>Cheap tariffs withdrawn</i> – Some suppliers might withdraw cheap tariffs, meaning vulnerable customers would not be assured of saving without switching suppliers</p>

Modelling

To examine the likely outcomes of the three social tariff options for customers, we created a simplified model of the retail energy market. Our model assumes:

- That all customers are supplied by members of the Big Six¹⁵.
- That customers were on either a cheap fixed tariff or an SVT¹⁶
 - In our base case, the SVT price is the average SVT price of the combined Big Six on the 3/3/15 (£1,159)
 - The Cheapest tariff price is the average cheapest price offered by the Big Six¹⁷ on the same date (£1,006).
- We have assumed 25% of customers are on the cheapest tariff, with the remainder on the SVT¹⁸.
- That the Big Six suppliers would continue to make the same profits as per the year ending 2013¹⁹. In other words, suppliers respond to the scenarios by adjusting prices that maintain the same level of profitability as in the base case. In the scenarios we have modelled we have pre-determined the price of the SVT in each modelling run and allow the cheapest tariff price to adjust to ensure that the Big Six maintain the same level of profitability.
- The model also assumes Big Six suppliers are capable of providing discounts on their tariffs in a ratio proportionate to the number of customers they have on each tariff type. In other words, the larger the number of customers a supplier has on a SVT tariff, the larger the discount a supplier can offer to its cheapest tariff customers. This assumption also implies that the cost of supplying each customer in the market is the same²⁰.
- When changing some variables, we generally assumed the SVT price would not change, and that the cheapest tariff price would adjust to ensure that the Big

¹⁵ According to Cornwall Energy around 91% of all dual fuel customers are supplied by the Big Six. Cornwall Energy (2014) Competition in British household energy supply markets October

¹⁶ For the sake of simplicity we also ignored the prepayment market. This market operates in a different manner to the broader domestic supply market. DECC estimates that approximately 16.08% of all GB customers pay by prepayment

¹⁷ The cheapest average price includes white label tariffs where they are cheaper than the own label cheapest tariff.

¹⁸ There is no published figure for the proportion of customers on incumbent suppliers' SVT or cheap tariffs. The CMA found that 27% of all energy customers have switched energy suppliers in the last 3 years, most likely to cheap tariffs. We took a slightly lower figure, assuming that some of those customers would have since migrated on to SVT. The CMA also found that 50-90% of Big Six customers were on standard tariffs.

¹⁹ Consolidated Segmental Statements published by Ofgem.

²⁰ Costs can be higher to serve SVT customers than fixed price customers, especially with regard to bad debt levels.

Six maintain the same level of profitability. In practice, we are not sure this would be the likely result (see below).

- In our baseline model, we assumed there are 2.9 million households in the UK that would be eligible for the social tariff²¹. How you would identify such customers is considered below.
- We assumed that the most vulnerable customers were distributed in the same proportion as other customers, i.e. 25% on cheap deals, 75% on SVT. Evidence, including from the CMA²², indicates that the proportion of vulnerable customers on SVT is likely higher. However, in the absence of a precise figure, we decided to take the conservative assumption that the vulnerable customer proportions are the same as the wider population.

MODELLING RUNS

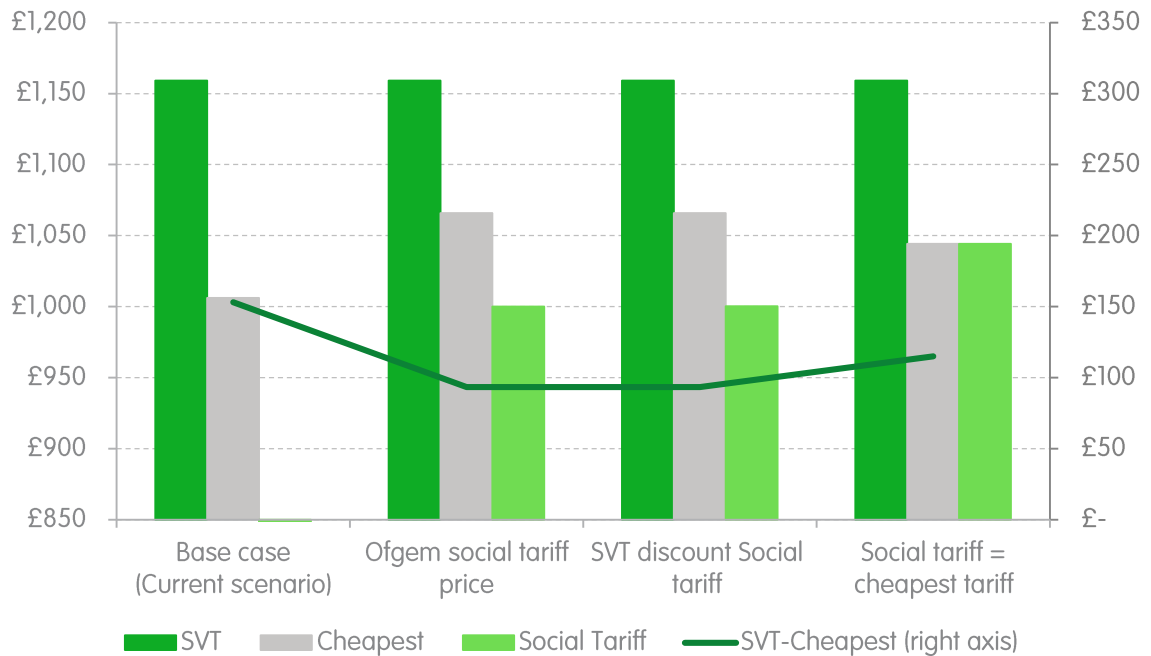
MODELLING RUN	APPROXIMATE NUMBER OF VULNERABLE CUSTOMERS	SVT PRICE	OFGEM SOCIAL TARIFF PRICE	SVT DISCOUNT AMOUNT
1	2.8m, 11% of domestic market	£1,159	£1,000	£159
2	2.8m, 11%	£1,159	£950	£209
3	2.8m, 11%	£1,209	£1,000	£159
4	3.8m, 15%	£1,159	£1,000	£159

²¹ This is 11% of all English households. This is based on analysis from the Hills report and updated estimates from DECC.

²² Evidence from both Ofcom (which conducted a cross-sector research exercise on switching in various retail markets) and the CMA indicate that the number of vulnerable customers on SVT is likely higher.

Figure 1

Modelling Run 1. (£1000 Ofgem Social Tariff price)

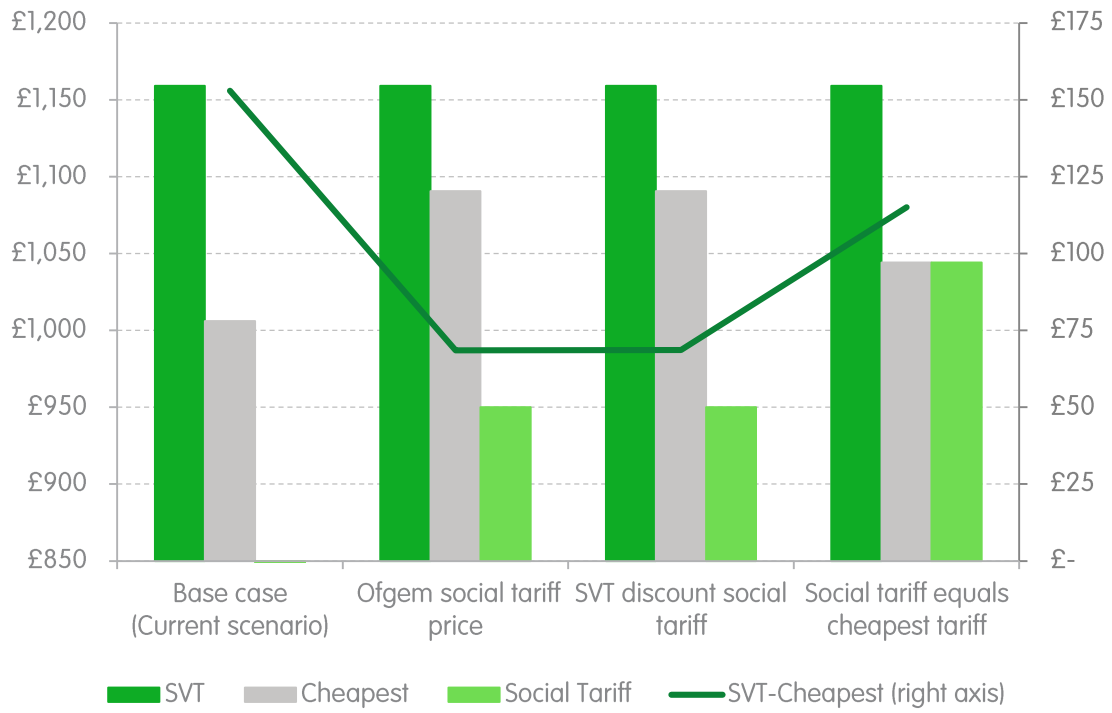


The first chart shows that there would be considerable savings for customers eligible for social tariffs who are currently on the high SVT, (£159, £159 and £111 in the Ofgem social tariff price, SVT discount social tariff and social tariff = cheapest tariff scenarios, respectively). It also shows that the social tariff = cheapest tariff would not deliver the same high level of savings for vulnerable customers. All three scenarios show that the ability of the incumbent suppliers to loss-lead would be significantly reduced. However, this assumes that they would not respond by putting up their SVT tariff to allow more aggressive cheaper tariffs.

This reduction in loss-leading is confirmed in modelling run two (below), when the social tariff has been reduced further to £950. In this scenario, the ability of suppliers to loss lead is severely curtailed. The differential in the Ofgem social tariff scenario between the SVT and the cheapest deal has reduced from £93 to £69 (vs £153 in base case).

Figure 2

Modelling Run 2. (£950 Ofgem Social Tariff price, £209 SVT Discount)



Whether this would reflect suppliers' actual behaviour in such a market is difficult to predict. If previous patterns of behaviour continue, it is likely that some suppliers would push their SVT higher, in order to give them more leeway to offer loss-leading tariffs. This would be more likely if there was not an accompanying protection against loss-leading through a cost-reflectivity principle. This is tested in the below run, where the Ofgem social tariff is once again set at £1,000, but the SVT is raised.

Figure 3

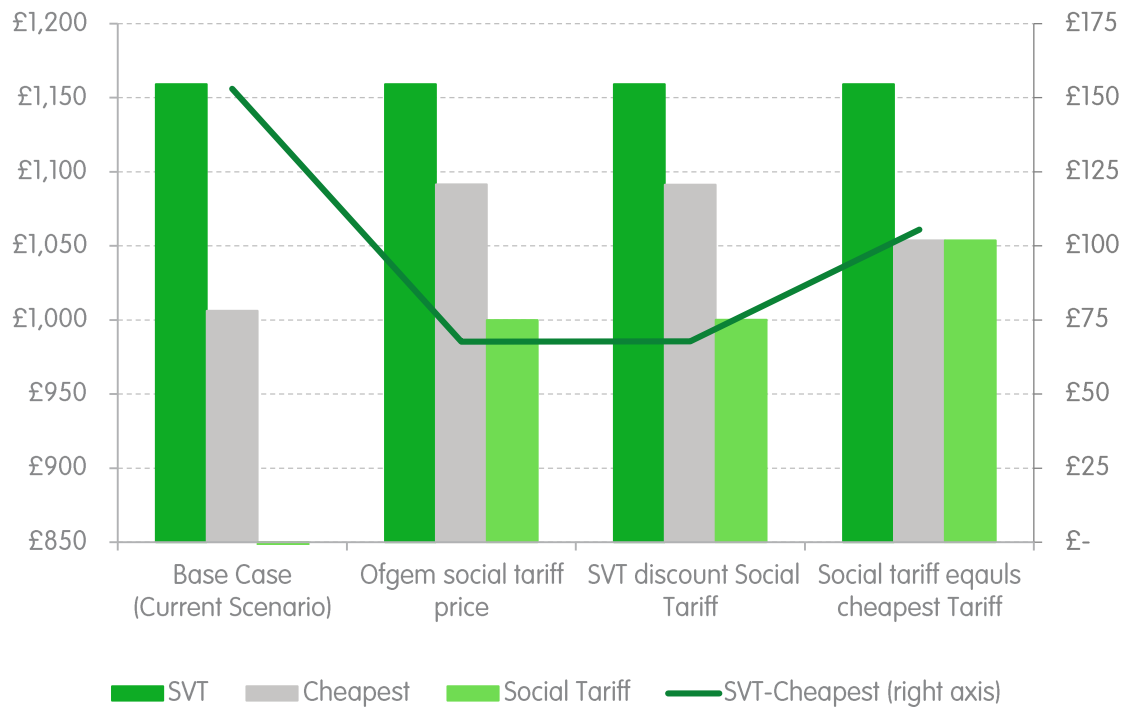


The first thing to point out is that the social tariff = the cheapest tariff is now the scenario out of the three with the cheapest social tariff. Our model also shows that increasing a supplier's SVT even slightly, greatly increases their ability to engage in loss leading. In this scenario, the option of the social tariff = cheapest tariff gives the greatest benefit to vulnerable customers. In effect, they benefit when differentials are very large. However, it is punitive to the customers remaining on the SVT. In short, it rewards an approach to pushing up the SVT. This risks amplifying current concerns in the market and would not be beneficial for *most* customers in the market.

The run also shows that the price of the SVT discount social tariff is now higher than the Ofgem social tariff scenario. This underlines the risks of linking the social tariff to the SVT, in addition to the uncertainty such a moveable price introduces. Of course, if we ran a model where the price of the SVT decreased, the social tariff price linked to it would fall. However, there is an obvious incentive not to do so, particularly if the sticky customer problem remains post-reform.

Figure 4

Modelling Run 4. (£1000 Ofgem Social Tariff price, Higher number of Fuel Poor)



Our final run shows the effect of increasing the number of customers eligible for a social tariff by 1 million. Unsurprisingly, this reduces the price difference between the SVT and cheapest in all scenarios. This implies that suppliers' ability to loss-lead would be reduced.

One of the main disadvantages of the SVT discount social tariff and the social tariff = cheapest tariff options is the price uncertainty they introduce. Previous efforts to introduce social tariffs (see Box 2), have lost support because different customers were getting different prices and savings for individual customers were not always clear. Certainty in this area is likely to be valued by customers, which supports the Ofgem-set social tariff approach.

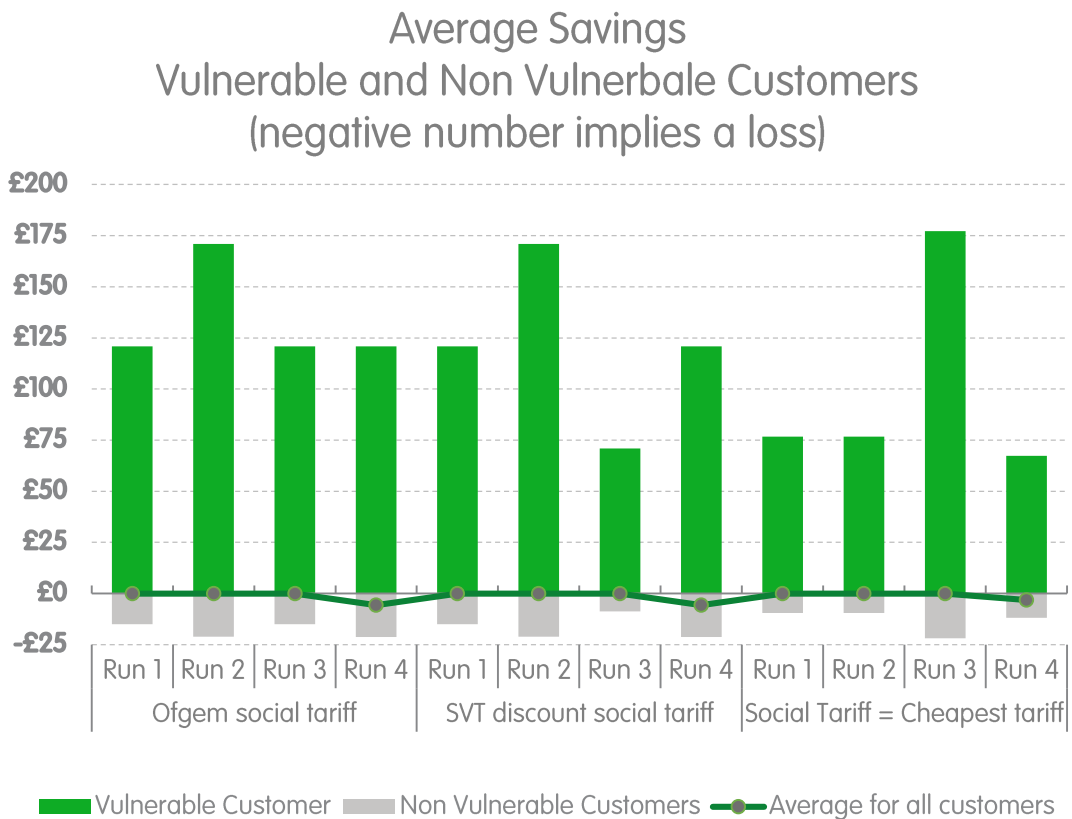
BOX 2. HISTORY OF SOCIAL TARIFFS

Social tariffs were offered by many suppliers during the voluntary agreement scheme that preceded the introduction of the Warm Home discount in 2011. A key weakness of previous social tariff schemes was that targeting and rules were left broadly to supplier. As a result, there was little consensus on what the price of a social tariff should be or who should be targeted. As a result, different suppliers offered different discounts to different groups of customers. Often, better off customers tended to benefit and some social tariff customers would have been better off on another supplier's social tariff.

As we have identified, the most vulnerable customers are amongst the least active consumer group in the retail energy market. As a result of this, and because customers had to self-identify for the voluntary scheme, suppliers failed to enrol all eligible customers. Moreover, there was little consumer pressure on prices or offers which meant that social tariff prices varied considerably from supplier to supplier. As a result, the voluntary scheme was, unsurprisingly, confusing and unhelpful to vulnerable customers.

GAIN LOSS ANALYSIS

Figure 5



The chart shows that the savings for vulnerable customers are more consistent if an Ofgem-set social tariff is introduced, no matter how the rest of market reacts. The average saving is £133 across the four model runs, compared to £121 and £100 for the two other options (see table below)²³.

MODELLING RUN AVERAGES	<i>Ofgem social tariff</i>	<i>SVT discount social tariff</i>	<i>Social tariff = cheapest tariff</i>
AVERAGE VULNERABLE CUSTOMER SAVING	£133.41	£120.91	£99.51
AVERAGE NON VULNERABLE CUSTOMER SAVING	-£18.08	-£16.53	-£13.19
AVERAGE FOR ALL CUSTOMERS	-£1.42	-£1.42	-£0.79

CONCLUSIONS AND RECOMMENDATIONS.

Our analysis leads to the following conclusions:

- In all scenarios, vulnerable customers currently on high SVTs would benefit from the introduction of some kind of social tariff.
- Under the four different runs, the Ofgem-set social tariff has a higher-than-average saving compared to the other two.
- It also has the advantage of certainty for the relevant customers. How suppliers would respond to removing a group of customers from the market is extremely uncertain, particularly if it is not accompanied by clear rules against loss-leading.
- All the scenarios also reduce the ability of suppliers to loss-lead to some extent. However, there is a risk that the differential between SVT and cheapest deal could actually increase if suppliers took the signal that they no longer had to worry at all about pushing up SVT prices if vulnerable customers had been removed.
- This underlines why such a change must be accompanied by a clear pricing principle of cost-reflectivity. This avoids the risk of continuing segmentation of the market.
- All the scenarios do lead to a small loss for the wider market. However, it is worth stressing that most of this 'loss' is where the cheapest deals in the market from incumbent suppliers are removed. It is likely that cheap deals from suppliers who can operate at lower margins will remain. The existence of deals cheaper than the social tariff means that there remains a competitive incentive for social tariff customers to engage in the wider market if they choose to.

²³ Average for all customers implies the policy cost. Note that is only negative in the modelling runs where there is a higher fuel poor assumption.

- If incumbent suppliers want to compete on price, they have to reduce costs and innovate, rather than simply relying on loss-leading tariffs cross-subsidised by inactive customers on high SVT prices. This is exactly the kind of pressure you are hoping for in a competitive market.
- Our recommended way of delivering protection for vulnerable customers is a social tariff set annually by Ofgem.

DISADVANTAGES OF AN OFGEM-SET SOCIAL TARIFF AND HOW TO OVERCOME THEM

- Ofgem would be required to set a price for social tariffs. This may not be straightforward and if it was done on a similar basis to price regulation for networks, could be burdensome. Ofgem has historically been reluctant to intervene in pricing in the energy market. The entire Retail Market Reform process could be seen as a well-intentioned, but ultimately unsuccessful, attempt to force energy companies to price fairly via every possible mechanism except price regulation. However, it is clear that RMR has not stopped the high differential between the Big Six's SVTs and cheap deals. This remains the most damaging characteristic of the energy market.
- Ofgem has shown itself capable of regulating prices for the networks businesses. Moreover, there is much greater amount of information about what suppliers are willing to charge customers available in the market, making such a process much more straightforward. We see no reason why it would not be both feasible and appropriate to extend this activity to a small, but otherwise effectively stranded, section of customers for whom the benefits of competition may never become a reality.
- As we have discussed, the Ofgem social tariff model does not, by itself, limit the ability of suppliers to offer loss leading tariffs and charge high SVT prices to sticky customers. This underlines why it is necessary for the introduction of a cost-reflectivity pricing principle that would be rigorously enforced by Ofgem.
- There is a risk of social tariff customers being actively avoided by suppliers, as they would make less money in supplying them. This could be by offering them lower quality service or avoiding customers in particular postcodes or with a particular credit history. The purpose of introducing a social tariff scheme is to protect vulnerable customers, not to punish suppliers with a higher proportion of customers that are vulnerable. As such a reconciliation process would be necessary in order to prevent suppliers from creating barriers to accepting vulnerable customers. The Warm Home Discount scheme is designed to prevent suppliers from benefiting if they have a low number of WHD customers. We would consider a similar mechanism under which suppliers were apportioned an obligation based on their market share would be the fairest solution to implementing our proposed social tariff scheme.

INTERPLAY WITH WARM HOME DISCOUNT (WHD)

As we have discussed, the WHD as currently designed often only reduces the problems of the market rather than addresses the fundamentals. For example, an average SVT customer will still be £101 worse off even after the WHD is applied compared to if they had just switched to the cheapest tariff.

If eligible customers are automatically placed on a reduced tariff under our proposals, they would get an even greater benefit from the WHD. If the social tariff was set at £1,000, they would get a net benefit of £299 compared to the average SVT prices on 3/3/15 (at average consumption). Improved identification means they could also be targeted for other measures to reduce bills, such as energy efficiency improvements.

Identification

Identifying vulnerable customers has traditionally been difficult for suppliers and was a problem in previous social tariff schemes (see Box 2). This is particularly the case when the criteria for vulnerability can be based on several unrelated factors such as household income, energy bill prices and the cost of heating an individual's home (depending on its efficiency and the efficiency of the appliances within in).

It is imperative that the problem of identification is overcome if social tariffs are to be widely taken up. If such a clear database cannot be established, the success of the proposed social tariff scheme is at risk. There are several options for how to classify potentially eligible customers:

FUEL POOR HOUSEHOLDS

The Hills Report²⁴ uses a low income, high cost indicator (LIHC) to categorise fuel poor customers. The Hills Report acknowledges however that the task of establishing who is eligible via the LIHC is complex. The data is simply not available yet to reconcile household heating costs with income levels and energy bills on the scale required. Under the Hills definition, there are around 2.9 million households in fuel poverty (the number we have used on our base line modeling).

THE COLD WEATHER PAYMENT SCHEME (CWP).

The CWP is a social welfare payment made to eligible individuals during periods of very cold weather. The current payment amount is £25 per week when temperatures are below zero. Eligible Applicants include those in receipt of: the guaranteed element of pension credit, Income Support, income-based Jobseeker's Allowance, income-related Employment and Support Allowance and those in receipt

²⁴ Hills, John (2012) Getting the measure of fuel poverty; Final Report of the Fuel Poverty Review

of Universal Credit. The Government makes the payment by reconciling eligible benefit recipients with postcode and weather data. Latest figures from DECC suggest that there are 3.8million individuals eligible in Great Britain.

THE WARM HOME DISCOUNT SCHEME (WHD).

The WHD is a rebate paid to eligible energy customers via a discount on their energy bill. The current discount amount is £140. The scheme consists of two groups the core group and broader group. The Core group consists of poor pensioners and the broader group is a group of people either in receipt of benefits or on low incomes.

In the absence of a comprehensive list of Fuel Poor households, we consider that the CWP dataset would represent the best option for the following reasons:

1. The CWP includes information on household income levels and is means tested for most applicants. Income levels are a key variable in assessing who is fuel poor via the LIHC.
2. The CWP scheme data is already centrally administered unlike a significant proportion of the data for the WHD which is held by individual suppliers (although some it can be checked against DWP data).
3. The CWP scheme data is organized by postcode to reconcile with local weather stations. The Department of Work and Pensions (DWP) could simply match data sets with suppliers, in a similar process to the one used for the core group of the WHD scheme.

The Centre of Sustainable Energy (CSE)²⁵ estimated CWP covers almost 60 per cent of the poorest 20 per cent of all households. Of this group 66 per cent of those eligible for the CWP were predicted to have never switched supplier, in contrast to 50 per cent of the population as a whole.

²⁵ CES (2015) Energy Tariff Options for Consumers in Vulnerable Circumstances Paper - Final Report to Citizens Advice