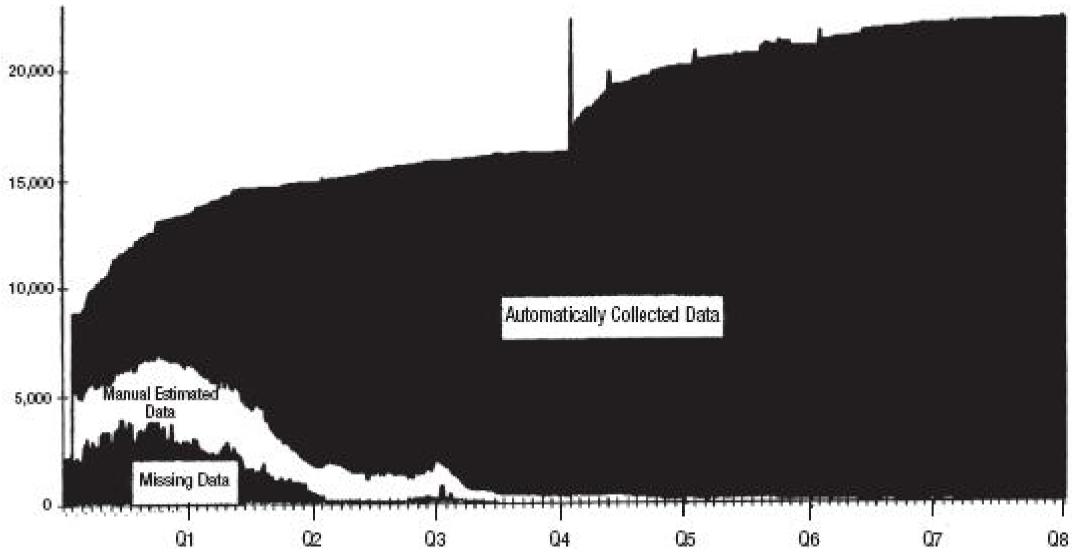
Article for New Power on Retail Competition, May 2011, Alex Henney[1]

My book "The British Electric Industry 1990-2010: the rise and demise of competition" covers all of the electric industry – the wholesale market with the wasteful and fruitless creation of the New Electricity Trading Arrangements which together with the creation of the oligopoly the first two step in the demise of the market; the nuclear roller coaster; the corporate whirligig that led to the formation of the oligopoly which was the second step in the demise of the markets; how smart metering is being provided unsmartly and expensively; the initial failure of effective network regulation followed by a slow learning process to innovative approaches; and the greening of the electric industry, including the failure to deliver by both the European Emissions Trading Scheme and the Renewables Obligation, which is fundamentally flawed, and the impossible and expensive ambitions for 2020. These are not only the death knell of the market, but also raise the question of when will the wheels come off the venture as the cost becomes apparent and people realise the futility of our puny unilateral efforts to impact on climate change while China and India pump out ever increasing volumes of CO2 from coal plant? The last sentence in the book is will someone in a decade write "The British Electric Industry 2011-2021: the rise and demise of greenery"?

The editor of New Power has a particular interest in mass market retailing, a topic on which he wrote a doctoral thesis in 2003 (1). There are three chapters in the book on retailing. The first covers "Opening competition to large and mid size sites", which took place for 1MW+ sites in 1990 and for 100kW+ sites in 1994. The first phase had its problems, but since there were relatively few customers and they were generally large and technically competent, the problems were dealt with. The opening of the 100kW+ sites was chaotic in part because Offer did not clarify responsibilities for ensuring that metering systems worked end-to-end; in part because it insisted on competitive supply even when sites did not have the systems, and the Pool went along with this naïve proposal; and in part because some of the distribution companies had not prepared their systems. The result was that initially a **third** of the sites that took competitive supply did not have any data, see exhibit. In consequence bills were wrong and late – and at peak more than £1bn was unbilled.

[1] Available from www.alexhenney.com.



The extension of competitive choice to the mass market was known as the "1998 project" because customers were supposed to have choice from 1 April 1998. The basis of a successful system project of this nature is to analyse options and undertake careful cost-benefit analyses (CBA) of the options. This never took place because the only party who could have done it – Professor Littlechild as Director General of Electricity Supply – initially tried to distance himself from responsibility. His refusal laid the seeds of economic failure. In December 1995 I wrote "The Proposals for Liberalising the Electricity Market in England & Wales in 1998 – A Poll Tax on Wires", which agreed that given the small quantity of electricity the average residential customer in Britain bought (about 4000kWh p.a.) "there was no justification for developing an enormous system to force-feed competition to small customers" and advocated a couple of much simpler approaches. My report was the only attempt to undertake a CBA.

Littlechild turned the project over to the Pool – which given its role and governance structure was not a suitable vehicle – and the Regional Electricity Companies (RECs). The outcome was fragmented decision making which resulted in consensus by complexity including the "supplier hub" concept and competitive metering, both of which for no useful purpose added complexity to an already complex and expensive project. A first attempt at developing trading arrangements centralized delivery of most of the systems onto the Pool, which Offer did not support. So the effort was recast. Littlechild was forced into accepting that Offer had to take responsibility for the progress of the project and appointed a Director of Supply Competition and PA Consulting as the overall project manager. One of the critical features of the implementation was the regulated fall back tariffs that were set to provide "headroom" to enable competition to "complete" profitably. Eventually, for a cost that was four times Littlechild's initial guestimate and some 9 months late, the project went live to be beset for a considerable time by extensive data errors.

The Trade and Industry Committee was very critical of Littlechild's failure to produce a CBA, and when he did it was an insult to the Committee, a meaningless set of figures which included a supposed benefit of £1bn for *increasing* consumption which we are now supposed to be prepared to pay several £bns for smart meters to *reduce* consumption! The Committee was "appalled to find that the [previous] estimates of the costs of liberalization presented by the regulator should have proven so inadequate." The Committee also observed "…neither the DGE nor the RECs can be proud of their collective inability to open up the domestic electricity market within the eight years since vesting…"

Once open, Ofgem under its new chief Callum McCarthy, with the complicity of the National Audit Officer, spun the benefits of competition over the years. This continued under John Mogg as chairman and Alistair Buchanan as Chief Executive, who equated switching driven by heavy selling with competition. They ignored the wide range of quality academic research which showed the market was not operating efficiently, with two tier pricing between customers who switched and those who did not; with many customers switching to *more* expensive suppliers; extensive misselling, misbilling and poor service. The Consumer Association pointed to the confusion for customers of the numerous tariffs.

One of the major changes to suppliers has been the significant development of their social obligations. Not only are there demands for higher standards in dealing with debt and disconnections, suppliers have increasingly been enlisted as welfare agencies to provide energy efficiency measures (which have become increasingly redistributional) and "social" tariffs which are clearly redistributional. This philosophy – which implies stealth taxation of the better off – is at odds with the clear view pre-privatisation that the electric industry was not a social welfare organization.

In late 2007 and early 2008 the electricity market was turbulent, and energy prices were high on the political agenda. Five of the six major suppliers announced significant increases of the order of 15% in their household electricity prices early in 2008, which led to the average combined average household bill for electricity and gas now exceeding £1,000 - the combined increase had averaged 55% over the past three years. The Chancellor of the Exchequer summoned the chairman and chief executive of Ofgem to see him on 16 January. Afterwards Ofgem issued a press release titled "Market is sound – Ofgem assures Chancellor", and they "confirmed that Britain's competitive market in energy is working" (2). Energywatch did not agree and was behind the strident headlines in The Sunday Times on 13 January 2008 "Energy rip-off exposed" and "Big six energy companies profit by inflated prices". On 5 February the House of Commons Business and Enterprise Select Committee launched an inquiry "Energy Prices, Fuel Poverty and Ofgem". Two weeks later Ofgem launched its "Probe into the energy supply markets".

In April Energywatch published a report that was very critical of the operation of the market behaviour of the Big 6 (3), calling for an inquiry by the Office of Fair Trading, and including a section of the report titled "Failings of regulatory oversight". In June, undermining Ofgem's reported claims about how satisfied customers were with the supply companies, market research for the government looked at the public perception of the electricity industry in a Consumer Condition Survey (5). The survey rated 45 UK markets to derive an overall Consumer Confidence Index. Gas and electricity came lowest - below betting and gambling, second hand vehicles and estate agents! Gas and electricity was the only industry to rank both *low* on quality, price, choice, expectations, consumer rights and advertising, and also *high* on complaints. Then the Business and Enterprise Select Committee published its report on 28 July 2008. It was concerned about the energy markets and was very critical of Ofgem, proposing a competition inquiry of Ofgem could not get its act together.

Ofgem published the "Initial Findings Report of the Energy Supply Probe" on 6 October 2008 (5) – it provided many significant examples of what were in effect market failures and subsequently commented "We identified in the Probe that while there is competition in the market, there are some segments of the market where competition is not intense." (7) Ofgem applied various bandaids for two-tier pricing and less than competitive pricing of pre-payment supply, improving the sales and marketing conduct of suppliers, and so on – but to little avail. In March 2011 Ofgem published "The Retail Market Review – Findings and initial proposals(8) which "has demonstrated that further action is needed to make energy retail markets in Great Britain work more effectively in the interests of consumers. Consumers are at risk from a number of features in the market which reduce the effectiveness of competition. We now have three investigations relating to our Probe remedies in progress. In addition to enforcing existing obligations, we believe that further radical actions are now required." The document has 5 proposals which it calls "radical", namely:-

- Make it far easier for domestic consumers to compare prices and choose a better deal
- Improve access to wholesale market products for new entrants and independent suppliers and generators
- Make sure the Probe remedies are strengthened, and where necessary enforced, so that they achieve their original objectives
- Take further action to prevent unfair contracting practices in the non-domestic sector
- Improve further the transparency in vertically integrated utilities

Worthy though these may be (they hardly merit the description "radical"|), they do not address the fundamental issue that I identified ex-ante and your editor identified ex-post, when he concluded that there would have been a net benefit in the range £1.2-1.6bn without competition but a regulated arrangement where wholesale price changes are passed through. Various figures that Offer/Ofgem have published over the years have highlighted the key problem – the gross margin of electricity supply/customer has increased substantially under competition:-

	£(nominal)	£2009 prices (approx)
1992/93 (below 100kW)	25	40
2001	35-42 (98/99 prices)	(say) 50
2009	88	88

In part this is due to the "costs of competition" including the costs of sorting out data messes; in part to the higher net margins; and in part to higher administration costs such as the more sophisticated computer systems that are needed; and in part to the exercise of market power. To these we can add the bothers of poor data, misselling, and misbilling. The basic issue is that unlike Texas and Norway, where the average annual residential consumptions are 20,000kWh and 16,000kWh, the residential consumption in Britain is too small to be worth the bother of competition.

The main objective of competitive – rather than regulated – prices could have been achieved more effectively in another way as your editor suggested. Thus in New Jersey and Alberta small customers who do not switch from their default supplier are provided with competitive prices (to the extent that the wholesale markets are competitive) by inviting wholesalers to bid for blocks of retail load which they supply for a period, and passing through the energy costs to the customers. This approach avoids the costs and hassles of misselling and of data transfer errors. *Message – keep it simply stupid.*

References:

(1) '*Determining the limits of competition. A critical evaluation of the process to introduce electricity supply competition*', Dominic Maclaine, DPhil thesis, University of Sussex, April 2003.

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(3) Why the British markets in gas and electricity require a competition investigation: An Energywatch discussion paper, April 2008.

(4) Report for BERR on the 2008 Consumer Conditions Survey, Ipsos MORI, June 2008, http://www.berr.gov.uk/files/file48855.pdf.

(5) Energy prices, fuel poverty and Ofgem, Vo1. 1, HoC Business and Enterprise Committee, 293-1, 16 July 2009, http://www.publications.parliament.uk/pa/cm200708/cmselect/cmberr/293/293i.pdf.

(6) Energy Supply Probe – Initial Findings Report, 140/08, Ofgem, 6 October 2008, http://www.ofgem.gov.uk/Markets/RetMkts/ensuppro/Documents1/Energy%20Supply%20Probe%20-%20Initial%20Findings%20Report.pdf.

(7) Addressing undue discrimination, Final Impact Assessment, 73/098, Ofgem, 26 June 2009, http://www.ofgem.gov.uk/MARKETS/RETMKTS/ENSUPPRO/Documents1/Addressing%20Undue%20Discrimination%20-%20final%20impact%20assessment.pdf.

(8) The Retail Market Review – Findings and initial proposals, 34/11, Ofgem, 21 March 2011, http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/RMR_FINAL.pdf.