National Audit Office

# Protecting consumers? Removing retail price controls

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 342 Session 2007-2008 | 28 March 2008

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**20 March 2008**

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# SUMMARY

**1** Between 2002 and 2006, Ofcom, Ofgem and Postcomm removed retail price controls from fixed line telephone provision, gas and electricity supply, and Special Delivery (Next Day) for business account users.[1] The controls had been instituted to protect consumers from potentially unfair pricing, and encourage efficiencies in suppliers that had once been monopolies, and which retained large market shares. Ofcom, Ofgem and Postcomm removed the controls because they considered that competition had developed sufficiently to rely on the market, and on the restrictions imposed by competition law and consumer protection rules to protect consumers, without the need for price regulation. Furthermore, all three regulators have a number of statutory objectives, one of which is to protect consumers through the introduction of competition, where appropriate.[2] The markets under review are worth some £46 billion per year, and in telecoms and energy supply services to almost every household in the UK **(Figure 1)**.

**2** Price controls carry risks for consumers. For example:

- if the regulator cannot predict accurately the future costs of an efficient supplier it might set prices too high, resulting in consumers paying too much;
- or it may set prices too low, resulting in suppliers being unable to invest adequately;

- price controls do not always protect consumers from price volatility as, for example, when wholesale energy prices need to be reflected in the prices paid by consumers; and
- price controls may limit the incentives for a supplier to be innovative.

The removal of price controls also carries risks to the consumer, especially if consumers are unable to take advantage of competition or suppliers act in an anti-competitive way. The removal of price controls and the reliance on competition legislation and consumer protection rules will therefore represent value for money only if the markets concerned are developed to a level where consumers are protected by competition and have the potential to benefit from it. We looked at:

- whether regulators monitor markets to ensure that effective competition is developing (Part 2);
- whether regulators have enabled consumers to take advantage of competition (Part 3); and
- whether regulators took the right steps when removing retail price controls (Part 4).

This report evaluates whether Ofcom, Ofgem and Postcomm have achieved these aims. It evaluates whether the regulators went about removing price controls in a manner most appropriate to meeting their statutory objectives. The report also draws out good practice and lessons learned in the process of removing price controls, to which regulators considering similar action, such as the Civil Aviation Authority, can refer.

## Conclusion

**3** Assessing the outcomes of the removal of price controls on consumers and the market is complex and depends upon a mix of factors, some of which regulators cannot easily influence. Furthermore, there are some gaps in the data available to monitor the effectiveness of markets. Some things are clear, however. The processes used by Ofgem, Ofcom and Postcomm for removing retail price controls were consistent with the regulators' statutory duties of protecting consumer interests through the promotion of competition. The conditions for competition have developed in all three markets where price controls have been removed, and the regulators have taken action to help consumers take advantage of competition, for example, by ensuring that consumers can switch easily between suppliers.

**1** Markets covered by the regulators under review

| Market | Telecoms | Gas/Electricity | Postal services |
|---|---|---|---|
| Regulator and date of establishment | Ofcom<br>Telecoms regulator (Oftel) originally established in 1984. Ofcom established in 2002. | Ofgem<br>Gas regulator (Ofgas) originally established in 1986, electricity regulator (Offer) originally established in 1989. Ofgem established in 2000. | Postcomm<br>Established in 2001. |
| Market size (£ billions) | 25 | 17 | The guaranteed next day express market is around £3.5 billion of which Special Delivery (Next Day – for business account users) is £125 million. |
| Number of customers in market (millions) | 30 | 27 (Electricity)<br>22 (Gas) | Approximately 476 million items delivered annually |
| Date retail price controls were removed | 2006 | 2002 | 2006 |
| Consumers affected by price control prior to its removal | All retail consumers (business and residential) | All retail consumers (business and residential) | Business mailers who use a Special Delivery on account service |
| Consumer body | Ofcom consumer panel is within the regulator. | Energywatch is established as a separate body and will be replaced by the National Consumer Council from October 2008. | Postwatch is established as a separate body and will be replaced by the National Consumer Council from October 2008. |

*Source: National Audit Office*

**4** However, while consumers have been able to apply competitive pressures in all three markets through switching, some problems remain. Some consumers, particularly those classified as vulnerable[3], are still unable to take full advantage of the competitive market for a variety of reasons, including complex tariffs and a lack of easily accessible, trustworthy, relevant, understandable and comparable information. In addition, the former incumbents (suppliers that in the past had monopolies) continue to have a strong position in their original markets. There remains a need, therefore, for all three regulators to continue to use their competition and consumer protection powers to ensure that markets continue to protect the consumer and that consumers can take further advantage of competition.

## Detailed findings

**5** Our detailed findings are:

### Understanding and monitoring the market

**a** **The available data shows that competition has developed to varying degrees in all three areas where price controls have been removed.** The former incumbents in energy have all lost market share to competitors, although they still retain a large share (46 per cent in gas, and just under 50 per cent in electricity). In the energy sector prices have risen since the price control was removed by around 60 per cent[4], but Ofgem consider that this reflects increases in the underlying costs. Prices in fixed line telephony have continued to fall after removal of the price control, for example the average cost of residential fixed line calls in 2006 was some £25 per month, down from £30 per month in 2002. BT, the former incumbent, still retains 37 per cent of the telecoms market, but this has been declining recently. In the postal sector, Special Delivery (Next Day – business account users) accounts for some 4 per cent of the guaranteed next day express market.

**b** **Where price controls have been removed all three regulators monitor the markets to assess whether competition is working effectively and consumers are protected, but have to focus on areas where data is readily available.** Ofcom and Postcomm, which removed retail price controls very recently in 2006, publish regular monitoring reports, as well as ad-hoc reports if they feel that there is a particular need. For example Ofcom's annual report *The Consumer Experience*, is published in a standard format that analyses market trends. Ofgem has a longer experience, having removed retail price controls six years ago in 2002. In the years following removal it used to publish annual reports, but now publishes full retail reports (such as the recently announced review of the domestic energy market)[5] and ad-hoc reports (such as on switching rates) only when it considers that there is an issue of interest, as it believes that competition is now effective and there is no need for routine reporting. For all three regulators, routine monitoring is limited by data constraints and the complexity of interpreting the indicators. For example, the relationship between input and retail prices in energy makes it difficult to monitor suppliers' margins, the increasing tendency for suppliers to bundle services in telecoms, and the pricing data for smaller express deliverers in post, create areas of uncertainty for regulators.

**c** **Interpretation of the indicators used for market monitoring is complex and regulators rely on professional judgement; furthermore, there are many factors that are partially or wholly outside the control of the regulator and which impact on consumer outcomes, such as wholesale prices in the energy market.** Individual indicators do not give enough information in isolation to determine whether the market is working effectively. For example, increasing prices relative to costs could indicate that firms are able to make excess profits, yet decreasing prices relative to costs could indicate that firms are trying to price new entrants out of the market. The regulators therefore have to use an element of professional judgement when interpreting the data, and look at the relationships between the indicators. This increases the scope for subjectivity in market analyses.

## Securing good market and consumer outcomes

**d** **The ability of consumers to switch supplier is essential so that consumers can drive companies to become competitive; most consumers who have switched supplier found it easy.** Research shows that over 90 per cent of energy and telecoms consumers who have switched found it easy to do so.[6] Postcomm found that 77 per cent of business consumers[7] who had already switched mail provider did not feel they faced barriers to changing supplier a second time. Evidence from consumer organisations and the regulators shows that problems remain for a minority – often the most vulnerable people.

**e** **There are many forms of protection for vulnerable consumers but these consumers still require particular attention from regulators.** Regulators have put in place protections for vulnerable consumers, such as licence conditions in energy and tariffs for those on low incomes in telecoms. Some vulnerable consumers, such as the elderly or those on low incomes, may be less engaged in the market and when they experience problems the impact is likely to be greater. Regulators are aware of these problems and are conducting research or establishing strategies to try and find remedies.

**f** **Many consumers find it difficult to take full advantage of competition because they cannot easily access information to help them choose the best deal.** In order to empower consumers to make the decisions that will help drive a competitive market, and thereby contribute to meeting the regulators' statutory duties on promoting competition, information needs to be easily accessible, trustworthy, relevant, understandable and comparable. Recent surveys conducted by the regulators and independent organisations show that 20 per cent of business postal users found it 'not very easy' to find information on cost[8], 27 per cent of fixed line telephony consumers had difficulty in making price comparisons between different suppliers, and initial research suggests between 20 to 32 per cent of electricity consumers looking to save money may have switched to a more expensive supplier.[9] Consumer information is provided by a variety of bodies; in particular the consumer bodies Energywatch and Postwatch have a specific consumer information function. Regulators are also taking a number of actions to improve available information, but the various regulators and consumer bodies have differing views on how proactive a regulator should be in this area.

**g** **Regulators have tended to focus on understanding and regulating the supply side of their markets, making assumptions about the consumer's response.** Until recently, regulators have focussed more on understanding and reforming the industry than on building an understanding of consumers. However, the regulators are now realising that competition and consumer policy are integral to each other and that they need to increase their understanding of how consumers behave. 'Behavioural' economics[10] can provide insights into consumer participation in a market which cannot be explained by traditional economic theory, and increasing engagement with consumers and suppliers can improve regulators' understanding of the market. There is more scope for the regulators to share learning and commission joint projects, for example, on understanding how low income consumers interact with the market.

## The decision to remove price controls

**h** **Regulators must make a professional judgement as to whether and when to remove a price control; the three regulators took different approaches to their decision making depending on the data available to make the judgement.** To determine whether a price control can be removed a regulator needs to evaluate the prospect for future effective competition using both qualitative and quantitative data. Postcomm set out specific criteria against which to measure the strength of competition, but had only limited quantitative data available and therefore concentrated on building a consensus in the industry on the prospects for effective competition against each of its criteria. Ofcom and Ofgem both had much quantitative data available. They both developed a set of indicators to measure the strength of competition, but did not set criteria for each indicator, instead relying on the direction of movement to determine whether competition was developing.

## Recommendations

### For regulators that have removed retail price controls

**1** Ofcom, Ofgem and Postcomm should strengthen their joint working and work with other sector regulators and the OFT, to understand better and engage with consumers, and develop their expertise in behavioural economics. This is consistent with the support for joint working expressed in the recent House of Lords Select Committee on Regulators.[11] Ofcom's consumer project on behavioural economics is a welcome development in this regard.

**2** Ofgem, Ofcom and Postcomm should maintain good oversight of the quality and availability of information available to consumers in their respective markets. Regulators may not always be the appropriate bodies to directly provide the information – this role may belong to a consumer body or a market solution – but their statutory duties require them to understand if gaps in provision exist and, where necessary, work with others to resolve any shortcomings. Examples of what more the regulators might do to achieve this are:

**a** Working with each other, the Financial Services Authority, the Office of Fair Trading, consumer bodies (including Energywatch which currently runs the code for switching sites in the energy sector) and the industry, to reduce potential consumer confusion by formulating and negotiating ownership of a single code to cover price comparison websites.

**b** Agreeing with, or requiring, suppliers to provide key information in a more consumer friendly format and through more accessible channels, both at the point of signing contracts and while using the service. It will be for the regulator and its stakeholders to decide the most appropriate requirements but two examples from other sectors or internationally which could be considered are:

- Key Facts Documents in the financial services sector in which companies are required to set out certain key elements of a product or service; and
- Yarra Valley (Australia) water bills which present usage graphically and provide comparisons with consumption in previous years, against the average for households of a similar size and against the level of the best.

**c** Considering how the incentives on companies to protect their reputations and brands can be used to achieve improved outcomes for consumers. Particular examples might be:

- For Ofgem, using their new role of setting complaints handling standards and reporting requirements as a contribution to more comparable information on quality of service across suppliers.
- For Postcomm, when it removes further price controls and as competition develops it should consider whether and what comparative information may be useful to postal customers.
- For Ofcom, completing and implementing its review on how to develop its consumer website 'Topcomm'.

There may be lessons which Ofgem, Ofcom and Postcomm can learn from the experience of regulators in other sectors, for example the Food Standards Agency's 'Scores on the Doors' scheme.

**d** Apply the five tests outlined by the Better Regulation Executive and the National Consumer Council to any consumer-facing information, PR or media campaigns produced by the regulator and encourage others within their sectors to do the same.

**e** Ofgem should push for a memorandum of understanding with the Department of Business, Enterprise and Regulatory Reform, the new National Consumer Council and the Office of Fair Trading on oversight and provision of easily accessible, trustworthy, relevant, understandable and comparable consumer information in the energy sector under the new consumer representation arrangements. Postcomm should consider similar action in the future if it removes further price controls that cover retail consumers.

**3** Ofcom, Ofgem and Postcomm need to ensure that in removing further price controls they continue to assess the impact on, and provide the necessary protection for, vulnerable consumers. As understanding and supporting vulnerable consumers in a competitive market is a key priority across sectors, regulators can learn lessons from each other's approaches.

**4** Where regulators publish monitoring reports in response to specific issues in markets where price controls have been removed it is not clear what criteria they are using to determine whether to report or not. Regulators should ensure that they report transparently and reduce the potential for subjectivity by specifying the criteria that they will use to determine when to report. Examples might include: setting trigger criteria or bands for certain sets of indicators, such as the level of consumer complaints, that, if breached, would prompt the regulator to issue a market report or investigate further. This should not preclude the regulator from intervening if it believes that there is other evidence of a problem worth investigating. Postcomm has removed only a single retail price control and this recommendation may become more relevant if it removes retail price controls over a larger area of the market.

**5** As competition develops further in those sectors where retail price controls have been removed, all three regulators will increasingly rely on their competition powers. Ofcom's and Ofgem's powers are held concurrently with the OFT which has much experience in their use. Postcomm's powers are not concurrent, but it has replicated competition powers in its licence conditions. The three regulators should work with the OFT to learn from the OFT's extensive experience of using these powers.

## For other regulators considering removing retail price controls

**6** Postcomm and Ofwat have statutory objectives to promote competition where appropriate and they may decide to remove price controls currently operating in the postal and water sectors. In doing so, they should learn lessons from the experience of Ofcom, Ofgem and the removal by Postcomm of Special Delivery (Next Day – business account users) from Royal Mail's price control, and from the National Audit Office's work on regulatory impact assessments. In particular:

- Where possible, regulators should use both quantitative and qualitative data when deciding whether to remove price controls. In cases where quantified data is not available, regulators should judge whether they can make a transparent and robust decision based on the available qualitative data. In such cases, regulators should make greater efforts to obtain data, perhaps by commissioning primary research or through greater use of voluntary data sharing arrangements with industry.
- Regulators should ensure that their decision making is transparent and that it makes effective use of consultation responses. Regulators should clearly state in their decision documents the reasons why they have rejected the views of consultees who express dissatisfaction with the preferred option. The rationale behind changes made to the preferred option as a result of consultation should also be explained clearly and the evidence supporting it clearly sign-posted.

# PART ONE

## Introduction

**1.1** During the 1980's the then Government privatised the formerly state owned providers of gas, electricity, telecoms and water.[12] The privatised companies initially inheritied monopoly or dominant positions in their markets. One of the measures established by the Government to protect consumers against the potential risks posed by the position of the companies was a system of price controls overseen by economic regulators. Price controls were also designed to encourage suppliers to become more efficient while competitive pressures were weak. Similar arrangements were established in the postal industry due to the dominance of Royal Mail. Postcomm was established as the postal services regulator in 2001.

**1.2** As competition developed in these industries, the regulators felt able to reduce the extent of the price controls, in most cases starting with those covering larger, mainly business, users. Latterly, between 2002 and 2006, Ofcom and Ofgem removed price controls for retail customers for fixed line telephone provision, gas and electricity supply. Following the opening up of the postal market to competition in January 2006 Postcomm removed Royal Mail's Special Delivery (Next Day – for business account users) product from the price control. This Part of the report sets out the retail price controls, the reasons for their removal and the scope and nature of our examination.

### Price controls covered monopoly or dominant suppliers

**1.3** The retail price controls removed by the three regulators covered the following activities:

- **British Telecom (BT):** The retail price control was first introduced in 1984 and covered the price of a basket of retail telephony services: local and national calls, operator assisted calls and exchange line rental. The final retail price control prior to removal applied to the supply of these services to the lower 80 per cent of BT's residential customers by spend, covering some 30 million customers and a market worth some £25 billion in 2006-07. Ofcom allowed the control to lapse in August 2006.
- **British Gas Trading (BGT) and 14 Regional Public Electricity Suppliers (PES):** In the gas market, British Gas was privatised as a single concern operating throughout Great Britain, and subject to a national price control. In the electricity market, the 14 Public Electricity Suppliers (PES) were privatised as regional monopolies and the prices in their monopoly 'home' area were subject to a separate price control for each company. The retail controls applied to some 27 million customers and a market worth some £17 billion in 2006-07. **Figure 2** sets out the key milestones in the removal of retail price controls in the gas and electricity markets.
- **Royal Mail:** Royal Mail has a dominant position in the mail market and is the only body subject to a price control. The price control covers a basket of goods which includes the following: retail first and second class, bulk first, second and third class (including Presstream)[13], standard parcels, some international products and Special Delivery (Next Day sold at Post Offices). None of Royal Mail's other products are price controlled. Postcomm introduced competition into the market in 2002 and from 1 January 2006 opened the market to full competition allowing any licensed company to compete with Royal Mail. The price control on Royal Mail's Special Delivery (Next Day – for business account users)[14] service was ended from April 2006.[15] All other price controlled products remain in the control.

**2** Key dates in the development of competition in the domestic energy market

| | |
|---|---|
| 1986 | British Gas privatised |
| 1989 | Regional Public Electricity Suppliers (PES) privatised |
| Apr 1996 | Domestic gas customers able to switch for the first time |
| Feb 1997 | British Gas plc de-merged into BG and Centrica |
| May 1998 | Domestic gas market fully opened to competition |
| Sep 1998 | Domestic electricity customers able to switch for the first time (Centrica starts to supply electricity). |
| May 1999 | All PES supply areas fully opened to competition for domestic electricity. |
| Apr 2000 | Direct Debit customers removed from the control, but price controls remained on PPM, Standard Credit and Prompt Pay tariffs. |
| Apr 2001 | Centrica's April 2000 price caps removed, except for relative price limits on pre-payment meters. |
| Apr 2002 | All price controls lifted on gas and electricity. |

*Source: Ofgem*

## The regulators judged competition capable of protecting consumers

**1.4** The statutory objectives of Ofcom, Ofgem and Postcomm task them with protecting consumers through the introduction of competition, where appropriate (Appendix 2). The use of price controls can create risks for consumers, as well as benefits. For example, there is always a limit on the ability of a regulator accurately to predict the future costs of an efficient supplier, creating the risk that prices might inadvertently be set either too low, resulting in the inadvertent discouragement of competition and the dominant supplier being unable to finance the provision of the standard of service customers desire, or too high, with the result that consumers pay more for services than they need to. Furthermore, price controls did not necessarily protect consumers from price volatility as, for example, changes in wholesale energy prices were passed straight through to consumers.

**1.5** Accordingly, while the regulators have retained price controls in areas where operators retain monopoly or dominant positions, they have seen competition, where it is strong enough, as a better protector of consumers' interests. If competition works effectively it should allow all consumers to benefit. This is because, in an effective market, those consumers who become actively engaged by switching suppliers will force suppliers to become more efficient, with the benefits being passed on to all consumers, even those who are not actively engaged.

And even where the price controls have been removed, the companies affected continue to be subject to the same general competition law affecting all suppliers of goods and services, as well as licence conditions in the energy and postal sectors. Price controls continue to operate over BT's sale of wholesale line services, over gas and electricity transmission and distribution and over most postal services. The areas in the energy supply chain subject to price controls are shown in **Figure 3 overleaf**.

**1.6** The removal of retail price controls does not bring an end to the role of a regulator. There remains a need to strengthen competition further, because some risks such as consumers being unable to take advantage of competition, or suppliers acting in an anti-competitive way may remain, particularly in the early stages of competition. Furthermore, if suppliers are able to differentiate those consumers who are actively engaged in the market from those who are not, they may be able to discriminate against the later group. Regulators must therefore ensure that they regulate for these risks, to ensure that competition works effectively, and separately that suppliers can meet their social obligations.

## We examined the effectiveness with which regulators have removed retail price controls

**1.7** The overall picture of competition and the benefits for consumers, following the removal of retail price controls, appears to vary in each sector. The majority of incumbents, such as BT, British Gas and the former Public Electricity Suppliers, retain close to 50 per cent of their markets, raising the question of whether they may still be able to exert significant influence. Furthermore, energy prices rose sharply following wholesale cost increases in 2004, peaking in January 2006, and wholesale costs continue to be volatile, whereas the cost of fixed line telephony has been falling for a number of years. We therefore decided to examine the effectiveness with which regulators have removed retail price controls and sought to protect consumers through competition, focusing on:

- whether regulators monitor markets to ensure that effective competition is developing (Part 2);
- whether regulators have enabled consumers to take advantage of competition (Part 3); and
- whether regulators took the right steps when removing retail price controls (Part 4).

**1.8** More information on audit scope and methodology is at Appendix 1. Appendix 2 provides a historical and conceptual overview of price controls in the UK, and Appendices 3 to 5 describe the processes used by Ofcom, Ofgem and Postcomm. Appendix 6 provides information on market data and Appendix 7 on the consumer switching journey.

## 3 The Energy Supply Chain and Price Controls

| Costs associated with the supply of domestic energy | Price controlled prior to the removal of retail price controls? | Price controlled after the removal of retail price controls? | |
|---|---|---|---|
| Wholesale cost of energy bought by suppliers. | No | No |  |
| Cost of energy transmission and distribution to the customer. | Yes | Yes |  |
| Cost of supplying domestic customers, including billing and customer services. | Yes | No |  |
| Cost of energy paid for by domestic customers. | Yes | No |  |

*Source: National Audit Office*

# PART TWO

# Do regulators know whether the market is sufficiently competitive to protect consumers?

**2.1** To successfully remove price controls a regulator needs to assess beforehand whether competition is established enough to protect the consumer from excessive prices, and subsequently, to monitor whether this remains the case. This Part examines the work of the three regulators in this area. It shows that:

- Ofcom, Ofgem and Postcomm all monitor the market to assess the state of competition, but they do so to varying degrees, depending on their assessment of the effectiveness of competition and the maturity of the market.
- Regulators monitor the market where data is available and rely on their professional judgment in interpreting the indicators. They do not generally use a fixed framework or benchmarks for determining the effectiveness of the market, but rather use some key indicators that are monitored regularly. This means that there is a degree of subjectivity in market monitoring.
- Competition has developed in all three areas but the former incumbents in energy and telecoms still have large market share, and in the energy sector the incumbents are also able to price above the best alternative provider.

## Ofcom, Ofgem and Postcomm monitor the market in different ways

**2.2** All three regulators in our study monitor the market in areas where price controls have been removed to determine whether the market is functioning effectively. Because of the different historical development of competition in the three markets, the regulators have different levels of experience of monitoring and have developed different approaches. However, they all use a set of common indicators that give information on how the market is working. **Figure 4 overleaf** lists the main indicators. This list is a generalised model that amalgamates all three regulators' approaches. They do not use all the indicators all of the time.

### Telecoms

**2.3** In the telecoms sector Ofcom has undertaken a large amount of market analysis. It has focussed principally on analysing the wholesale market, where BT is the dominant supplier, to ensure that competitors can take advantage of a level playing field created by the establishment of Openreach **(Figure 5 overleaf)**. This is also the area where Ofcom felt the main problems with creating an effective market lay and therefore the area on which it wishes to focus most closely. Ofcom's monitoring of the retail market is mainly focussed on ensuring that there are no blockages to competition and that new entrants can easily enter the market, but it also focuses on other factors such as prices.

**2.4** In future, Ofcom's monitoring of fixed line telephone prices may become more difficult as this service is becoming increasingly bundled with other products such as the internet, broadband, and television services. And because the price control was lifted in July 2006, experience of the operation of the market since then is still limited.

**4** Main market monitoring indicators used by all regulators

| Indicator | Interpretation |
|---|---|
| Prices | Comparative pricing data can be used in all three sectors to help assess whether competition is resulting in lower prices to consumers. However, interpretation is complicated by volatile input prices in the energy sector, the variety of product specifications offered by alternative postal suppliers, and by the bundling of services in telecoms. |
| Quality of service | Quality of service can be tracked by using data such as the level of complaints. However complaints may increase due to improved processes for complaints and a belief by consumers that complaining will make a difference rather than reflecting deterioration in service levels. |
| Market share | Market share data can indicate the level of competition that has developed in a sector and relative market power. The 'Herfindahl-Hirschman' index is often used to determine the levels of concentration of companies in a particular sector, and therefore the levels of competitiveness in the sector as a whole. |
| Profitability | A profitability analysis can indicate where firms are making excess profits and therefore the areas where competition is not working effectively. However, this data is often commercially confidential and difficult to interpret. Profitability data can also be difficult to interpret and depends on an understanding of factors such as how the company has allocated its costs. |
| Switching | Switching data gives an indication of how active consumers have become in the market. Interpretation is difficult as a low level of switching could indicate consumer apathy, or a high level of satisfaction. A high level of switching could indicate that consumers are actively participating in the market and thereby helping to drive prices lower, or a high level of consumer dissatisfaction. |
| Innovation and technological development | Innovation and technological development can indicate that competition is working effectively and that companies are responding to consumer needs. However, measuring innovation and understanding what level of innovation and development is necessary is complex. |

*Source: National Audit Office*

**5** The establishment of Openreach to provide a level playing field in Telecoms

A key issue for the removal of BT's price control was ensuring that the structure of the Telecoms sector at the wholesale level could support competition at a retail level. Following a consultation process to understand the dynamics of the market, Ofcom concluded that there was a risk that BT's operation of the "local loop" – the wires, cables, underground ducts and poles that connect most households to their local BT telephone exchange – could allow BT to favour its own retail operations above those of competitors, and thereby hamper the development of competition.

Under the Enterprise Act 2002 Ofcom could have referred this issue to the OFT for it to investigate any potential anti-competitive stance. However, in this case Ofcom reached agreement with BT on a structural solution in Lieu of a Reference under the Enterprise Act.

Under this agreement, BT created Openreach in January 2006. Openreach is managed separately from BT's retail operations and is responsible for providing all potential suppliers with access to the 'local loop' equivalent to that provided to BT's own retail arm. BT is also required to provide various wholesale products at a standard known as "equivalence of inputs" (EoI). By this standard, BT is obliged to use the same wholesale products and services itself as Openreach provides to other communications providers.

*Source: National Audit Office*

## Energy

**2.5** Ofgem has a long experience of monitoring the market as the gas and electricity retail price controls were removed in 2002. As Ofgem considers that effective competition has developed in the energy markets it stopped producing routine market monitoring reports in 2005 and the last published analysis of profitability in the electricity sector was in 2004. Ofgem instead publishes retail market reports on an exception basis, when it believes there is an issue that merits investigation. For example, in June 2007 it produced a market report which covered concerns that those on pre-payment meters were paying more than other consumers, and whether there was evidence of innovation in tariffs. Ofgem's analysis of the market uses a variety of indicators and data depending on what Ofgem considers is relevant. For example, Ofgem's June 2007 market report focussed on market share and in particular the level of switching by consumers in the market. Ofgem's market analysis focuses principally on the six main firms as they have virtually all the market share.

**2.6** The key difficulty in market monitoring that Ofgem faces is in analysing the extent to which competition is protecting consumers from unfair pricing. The wholesale energy markets are very volatile and energy companies have very different purchasing strategies depending on their view of how prices in the market will move. Ofgem does not currently monitor either a company's purchasing strategy, or its gross margins. Instead, Ofgem relies on other metrics, such as rates of switching and loss of market share if a supplier prices above the competition, to assess whether competition is putting effective pressure on suppliers to protect consumers.

**2.7** If the metrics that Ofgem uses to monitor the market demonstrate a failure of competition to protect the consumer adequately, Ofgem could then intervene or investigate further. For example, in response to recent concerns over rising prices Ofgem carried out internally a detailed analysis of the market which included comparing the observed increases in bills to a range of theoretical purchasing strategies, the impact of environmental schemes, and analysis of headroom available for new entrants looking to enter the market. This review concluded that there was no evidence that recent price rises had been a result of collusion in the industry. Nonetheless, Ofgem concluded in February 2008 that further investigation was needed to address mounting concerns among customers that could undermine confidence in competition, and announced a review of the domestic energy markets **(Figure 6)**.

### Post

**2.8** Postcomm has only recently removed the price control on Special Delivery (Next Day – for business and account users) and therefore has a very short time series of data. It is difficult for Postcomm to collect detailed data on the market segment where the price control has been removed, in particular as the market is deregulated. Furthermore, the market is fragmented.

### A framework for analysis

**2.9** Despite the fact that each regulator takes its own unique approach to monitoring, we were able to group their various analyses into five common key questions together with associated indicators **(Figure 7 overleaf)**. The table at Figure 7 is descriptive and amalgamates the approach of all three regulators – the regulators do not ask all the questions every time they analyse the market. It is not intended to be prescriptive, but could form a framework for market analysis.

**6** Ofgem review of domestic energy markets

On 21 February 2008 Ofgem announced a review of energy supply markets. This review will cover:

- The customer's perspective and experience of the market including access to information and barriers to switching supplier;
- Suppliers' market shares, switching rates for different groups of customers (such as online, dual fuel, single fuel and pre-payment);
- The competitiveness of suppliers' pricing in the different market segments and customer movement between payment types as well as suppliers;
- The relationship between retail and wholesale energy prices; and
- The economics of new entry and the experience of companies trying to enter the energy market.

The investigation will cover markets serving domestic customers and small businesses. Initial views from the probe will be published before the end of September 2008.

*Source: Ofgem press release 21 February 2008*

## The extent to which competition has developed varies in each sector

**2.10** The indicators that regulators use to monitor the markets require careful interpretation. For example, decreasing prices might appear good for consumers but could indicate that firms are trying to price new entrants out of the market, a strategy known as predatory pricing, to the long run disadvantage of consumers. Similarly, a rise in the level of customer complaints might indicate a deteriorating service but might also indicate that suppliers have made it easier for consumers to lodge complaints. We found that regulators recognise the need to use their judgement when interpreting market data, and to look at the relationship between different indicators to understand more broadly the development and effectiveness of the market, but do not have a fixed framework for doing so. This necessitates an element of subjectivity, and the lack of a framework means that the market may not be clear on the regulatory expectations.

**7** Key questions for market monitoring and data required

| Key question | Relevant indicator |
| --- | --- |
| Has competition developed in the market? | Market shares data for price controlled area<br>Market shares data for areas ancillary to the controlled products<br>Analysis of customers served by entrants and market segmentation of entrants<br>Analysis of entrant strategies – for example competition on price or service/providing services for big business customers or more general services. Analysis of ancillary and comparator markets<br>Introduction of innovative products. |
| Are operators responding effectively to competitive pressures? | Price movements in the market segment.<br>Price movements in ancillary markets and in comparator countries<br>Quality of service measures – range of services provided, customer complaints<br>Distributional analysis, for example via surveys and by consideration of prices/services for different consumer groups<br>Surveys of consumers' awareness of competition<br>Measures of switching behaviour |
| Are consumers benefiting from competition? | Consideration of the profits and margins of operators compared to normal returns in the industry and the cost of capital for the price controlled services (in other words, is the marginal consumer able to act as such or is price discrimination still a feature of the marketplace)<br>Incumbent and others' infrastructure investment and R&D expenditure<br>Development of price and service innovation<br>Technological development in the sector<br>Comparison of operators' margins and price movements |
| Is there potential for greater competition in the market? | Analysis of barriers to entry to the market and effects of removal of control<br>Analysis of developments in ancillary and substitute markets |
| Is the market as a whole developing effectively? | Volumes and revenue growth in the market<br>Costs (wholesale) development in the market<br>Employment development in the market<br>Environmental developments<br>Analysis of media and other stakeholder comment |

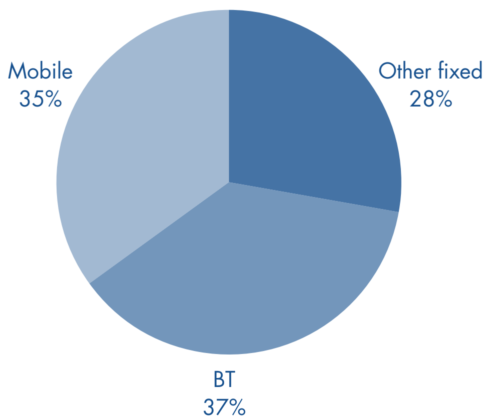
*Source: National Audit Office/Europe Economics*

## Telecoms

**2.11** There has been evidence of innovation within the telecoms market and there is now competition to fixed line telephony from substitutable products such as using a computer internet link in place of a fixed telephone connection. Ofcom research shows that nine per cent of households have dispensed with a fixed line altogether and rely on a mobile link. BT, the former incumbent operator, still has a large market share **(Figure 8)**, although this has been falling in recent years, even before removal of the price control **(Figure 9)**.

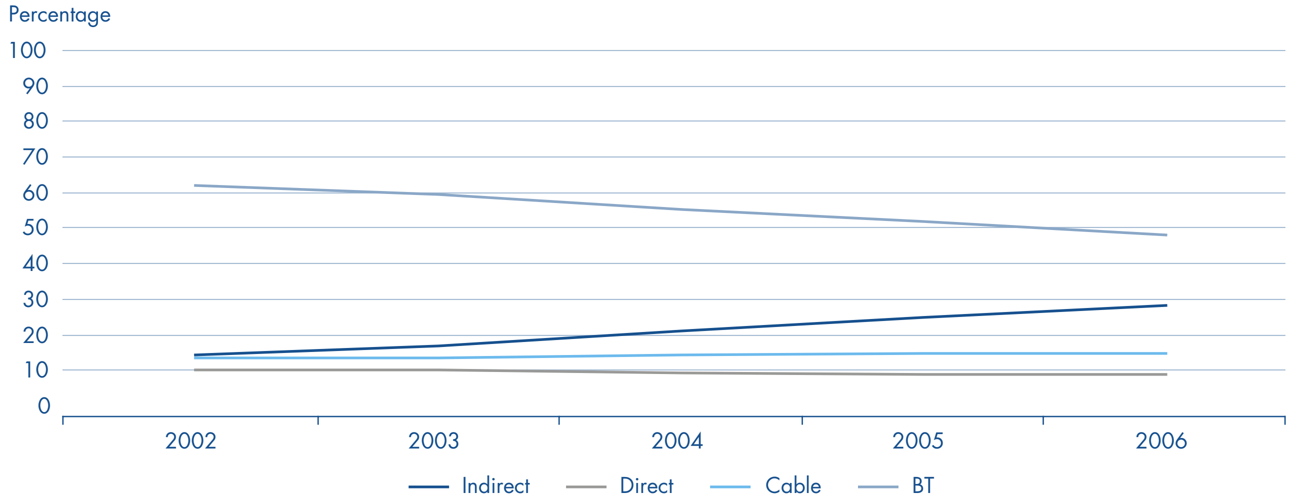
**2.12** The price of making fixed line calls has also been falling. For example, the average cost of residential fixed line calls in 2002 was some £30 per month, but this has fallen to around £25 per month in 2006. However, a recent international benchmarking study by the OECD found that prices are still higher than in a number of other developed nations **(Figure 10).**

**8** Market share of telecoms in 2006



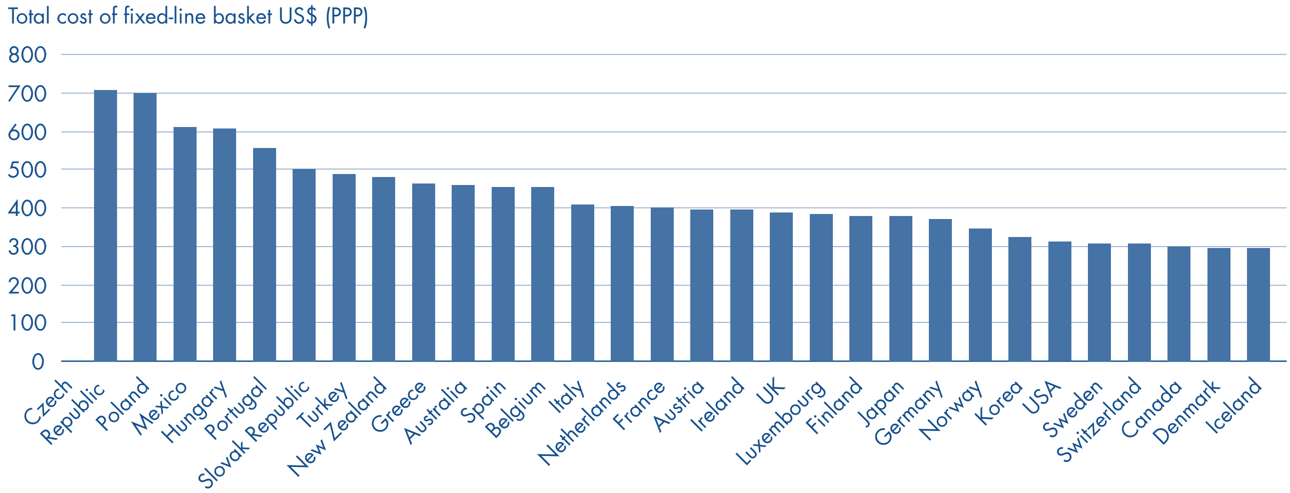

*Source: Ofcom, the UK communications market 2007*

**9** Market share of fixed call volumes




*Source: Ofcom, the UK communications market 2007*

**10** International comparison using OECD-defined residential low-use basket



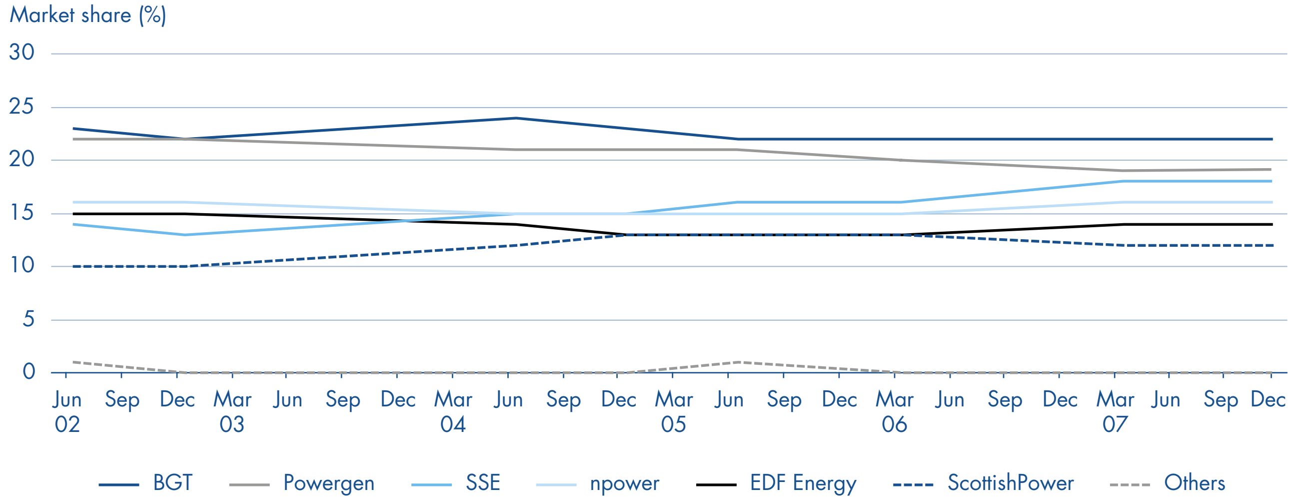

*Source: OECD Communications Market 2007*

**2.13** Research by Ofcom shows that, as at the end of 2006, 36 per cent of residential fixed line customers had switched supplier at least once, up from 28 per cent in the previous year. Seventy six per cent of consumers found the switching process either 'fairly easy' or 'very easy'. As fixed line telephone services become increasingly bundled with other services such as television and broadband it may become more difficult for consumers to switch that particular element of the bundle. However, it is likely that the service provider will increasingly take over the role of finding the best deal on the fixed line element of the bundle rather than the consumer.

## Energy

**2.14** Over the five years since removal of the price control, the incumbent in the gas market, BGT, has lost market share in gas to the other major energy companies. However, it still has a market share of over 40 per cent. The market share of the electricity providers has remained broadly constant as the regional incumbents have lost customers in their old monopoly areas but gained others elsewhere **(Figure 11 overleaf)**.

**11** National market share in electricity 2002–2007 (quarterly)




*Source: Ofgem, domestic market retail report June 2007*

**2.15** Retail energy prices broadly track the wholesale input prices both in gas and electricity. **Figure 12** shows that the cost of residential energy bills was broadly stable between 1998 and the middle of 2004, rose steadily until late 2006, before falling back. Energy prices continue to be volatile and Ofgem considers that this reflects underlying movements in the cost of wholesale supplies, although environmental costs such as the renewables obligation and the energy efficiency commitment are forming an increasingly large part of consumer bills.

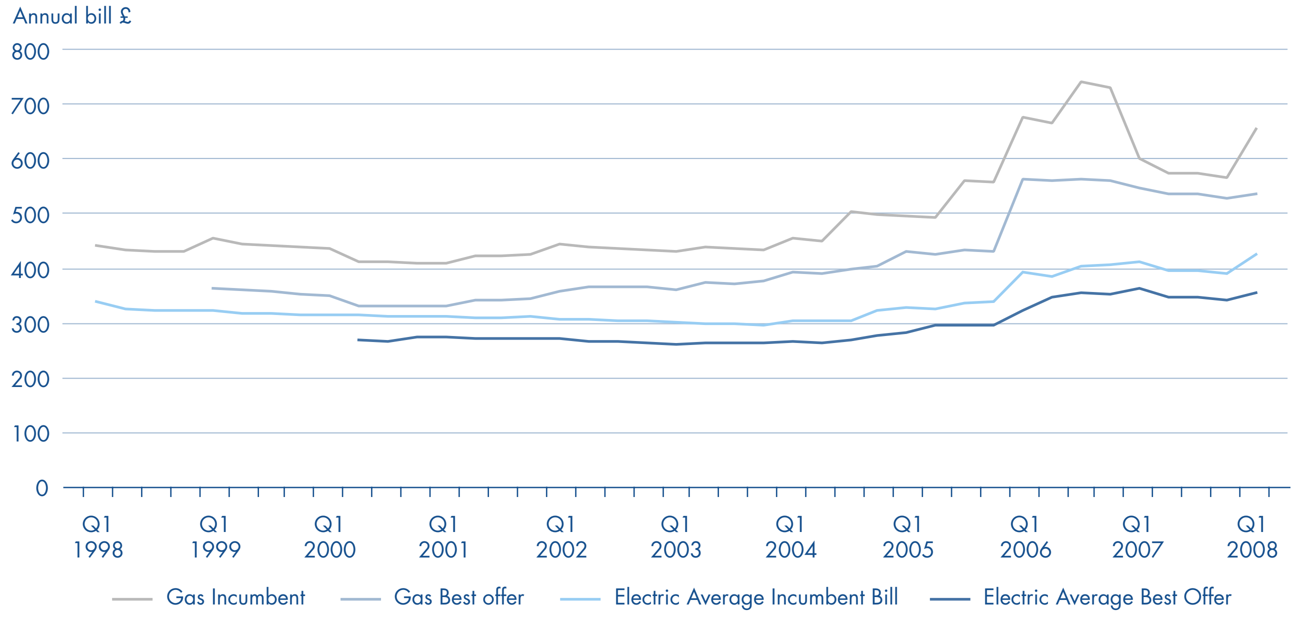
**2.16** The main area of innovation in the energy sector has been the introduction of a range of new tariffs, for example fixed price tariffs, which now account for some six million accounts. Online and green tariffs and schemes have also been introduced more recently. For example, one energy company offers a tariff with a free energy monitor, and the ability to earn credits for reducing energy usage.

## Post

**2.17** As the price control has only been removed from one Royal Mail product, analysis of market share is complicated by the definition of what constitutes a similar product from rival companies and the fact that there are many competitive express companies offering very similar products.

**2.18** Data on pricing is also problematic given that the market as a whole contains a range of products that have different attributes, for example delivery times, delivery tracking, or compensation in the event of loss. Looking at the UK guaranteed next day express market as a whole shows that Royal Mail has only a 14 per cent market share by value.

12 Domestic gas and electricity bills in real terms 1998–2008




*Source: Ofgem*

NOTE

Figures for Q1 2008 are based on all published price charges as at 8 January 2008.

# PART THREE

# Have regulators enabled consumers to take advantage of the market?

**3.1** In removing price controls, and placing greater reliance on competition to protect consumers, regulators need to be content that consumers are in a position to engage effectively with the market and apply competitive pressure on suppliers. Furthermore, if those consumers who are actively engaged in the market are able to apply competitive pressure across the market as a whole, this will benefit all consumers, even those who are not actively engaged. To achieve this, consumers need to have appropriate information on available products, and be willing and able to switch products or suppliers to obtain the deal they want. Furthermore, regulators need to understand how consumers respond to competition, and whether suppliers can identify and discriminate against those that are not actively engaged, to ensure that they can intervene if consumers are not driving the market as expected. Regulators also need to ensure that vulnerable consumers, who are less able to participate in the market, are not disadvantaged by competition.

**3.2** This Part evaluates the extent to which regulators have enabled these conditions in the market. It finds that:

- There is a lack of good quality consumer information and this is hindering the ability of some consumers to find and compare deals.
- Consumers find it easy to switch suppliers, following regulatory intervention to remedy problems in this area. But difficulties remain for a minority of consumers, particularly those who might be vulnerable.
- Consumers do not always act in ways that a regulator might assume, as price and quality of service are not the only things considered when choosing a product or service.

## There are shortcomings with the information available to consumers

**3.3** In order to make a decision about the deal that best meets their requirements, consumers require information which is easily accessible, trustworthy, relevant, understandable and comparable. Energywatch and Postwatch have a statutory function to provide consumer information in the energy and postal markets. However, all three regulators also provide some consumer information through websites, consumer publications such as fact sheets and leaflets and press releases on consumer focused issues – for example, encouraging consumers to switch suppliers to save money. Consumers may use a variety of other sources of information, such as, price comparison sites, media articles, advice from family and friends, suppliers' representatives, websites and other consumer organisations to make decisions about their energy, fixed telephony and postal supply.

## The regulators have different views on the consumer information they should provide

**3.4** We found the various regulators and consumer bodies had differing views on how proactive they should be in ensuring consumer information is both available and useful for consumers. This does not necessarily mean direct provision of information themselves but maintaining an overview of the quality and accessibility of available information and working with other bodies, including suppliers, to obtain any necessary improvements. Ofgem and Postcomm rely to a large extent on the market and their respective consumer bodies, who have a statutory function to provide information, while Ofcom have started to provide information to consumers directly.

### Ofcom has set out a proactive approach on consumer information

**3.5** We found that Ofcom has intervened where it considers it can improve the quality of consumer information. It has set out its approach to consumer information as "where the market does not deliver the information consumers want or need, Ofcom will consider appropriate intervention where this is deemed to be effective in improving the situation". Ofcom accredits companies' internet price comparison services and has created a website, 'Topcomm', which provides comparative quality of service performance indicators for all main telecoms providers.[16] Topcomm is in the early stages of development and Ofcom is considering how to take it forward, for example by increasing consumer awareness of the site.

### Ofgem and Postcomm have preferred to rely on sectoral consumer bodies to ensure provision of accessible, quality consumer information

**3.6** Under the Utilities Act, Energywatch has the function of providing information to energy consumers. Ofgem has thus relied on Energywatch to ensure consumer information in the energy sector is accessible, trustworthy, relevant, understandable and comparable. For example, Energywatch runs a voluntary code of practice for companies providing domestic electricity and gas price comparison services over the internet. However, the Utilities Act also provides that Ofgem may publish advice or information if it considers it is in the interests of energy consumers. Ofgem publishes a range of information and fact sheets on its website and runs a consumer phone line. It also carries out media campaigns encouraging people to switch.

**3.7** Postcomm has a stakeholder engagement programme which includes visits and meetings with customers and mail users. Postwatch has the function of providing consumer information to consumers and Postcomm also rely on suppliers to provide information to their customers or potential customers.

## Consumers find it difficult to access information or use it to find the best deal

**3.8** Our review of consumer research found that in all three sectors a significant number of consumers identified a lack of good quality consumer information. In surveys of consumers:

- 16 per cent of business postal consumers said it was 'not very easy' and 2 per cent 'very difficult' to find information on the types of services offered, with 16 per cent not knowing or having tried and 20 per cent finding it 'not very easy' to find information on cost, with 20 per cent not knowing or not having tried.[17]
- 30 per cent of fixed line telephony consumers found it difficult to make price comparisons between providers and 39 per cent found it difficult to make quality of service comparisons.[18]
- Around 20 to 32 per cent of electricity consumers looking to save money on their bills may have ended up switching to a more expensive supplier, potentially losing between £14 and £35.[19]

**3.9** In their report, *Warning: Too much information can harm*, the Better Regulation Executive and the National Consumer Council also found problems with regulated consumer information; for example consumer credit agreements can take up to 55 minutes to read and are presented in a language that many consumers do not understand. Furthermore, the volume of information contained in the agreements discouraged some consumers from reading any of the documents. These reports also defined criteria that regulators should apply when considering information requirements **(Figure 13)**.

**13** Five tests to apply when considering information requirements

1. Have you defined the behavioural outcomes that you wish to achieve?
2. Will information provide a sufficient incentive for consumers to change their behaviour?
3. To what extent does the information fit with the wider system and simplify choices for consumers?
4. Is the information aligned with business incentives, where this is possible?
5. Have you considered the fit with existing regulated information requirements?

*Source: Better Regulation Executive and the National Consumer Council*

## Ofgem's and Postcomm's new consumer responsibilities may provide an opportunity to review current approaches to information provision

**3.10** Under the Consumers, Estate Agents and Redress Act 2007, Ofgem and Postcomm will become responsible for setting standards on complaints handling by suppliers of energy and postal services. They may also require suppliers to publish information on compliance with the standards. The National Consumer Council must also publish appropriate statistical information on levels of compliance with the standards. This could provide a contribution towards the availability to consumers of more comparable quality of service information across suppliers. It could also provide the impetus for Regulators and the National Consumer Council to consider other opportunities for ensuring more comparable information is available to consumers. Postcomm may consider in future, as more price controls are removed and competition develops, whether comparative information would be useful to postal customers.

**3.11** The merger of Postwatch and Energywatch with the National Consumer Council under the Act provides an opportunity to review current approaches to consumer information. While Energywatch and Postwatch had the function of providing consumer information, there is no requirement on the new National Consumer Council to do the same; similarly to the regulators the National Consumer Council may publish information on consumer matters. Ofcom has a statutory Consumer Panel, which Ofgem and Postcomm do not. Ofgem are working with the Department for Business, Enterprise and Regulatory Reform, the new National Consumer Council and the Office of Fair Trading to determine where primary responsibility will lie for oversight and provision of consumer information under the new arrangements. There is a risk, however, that the transition to the new arrangements will leave gaps in the quality and accessibility of consumer information in the energy and postal sectors.

**3.12** It is not clear, for example, what will happen to the accreditation scheme for price comparison sites in the energy sector currently run by Energywatch. However, the existence of several accreditation schemes, while helpful in their own right, creates the risk of confusion and inaccessibility. Consumers may find it difficult to understand the need to use a different accreditation scheme when researching the best deals in the energy market than when researching deals in telecoms or financial services. A recent Resolution Foundation report suggested that sector regulators in energy, telecommunications and financial services work with the Office of Fair Trading, consumer bodies and the industry to formulate and negotiate ownership of a single code which would cover comparative websites in the fields of financial services, energy and telecoms.[20] Such a code would reduce the risk of customer confusion.

## Switching between suppliers has been made easier but a minority still suffer problems

**3.13** To ensure that competition is effective, the regulator relies on consumers to switch to a supplier who provides a better quality of service and price. Switching then puts pressure on the competitors to improve their prices and/or quality of service, to win back market share. The regulator must therefore ensure that consumers find it easy to switch between suppliers.

**3.14** Consumer research by the regulators shows that the vast majority of customers find it easy to switch supplier. Of those consumers that had switched, 89 per cent said this was 'fairly' or 'very' easy in telecoms. The equivalent figure in gas was 86 per cent. This finding is supported by a National Consumer Council survey which found that 95 per cent of energy consumers and 94 per cent of fixed telephony consumers who had switched provider had found it very or fairly easy to do so.[21] Postcomm found that 77 per cent of those who had switched mail provider once did not feel they faced barriers to move.[22]

**3.15** Despite these overall findings, a minority of consumers experience serious problems when trying to switch provider in the energy and fixed telephony markets through misselling, inappropriate billing, poor customer service or inadequate administration procedures **(Figure 14)**. For example, Energywatch receives around 2,000 complaints per month from domestic consumers related to switching energy suppliers. Ombudsmen exist in the telcommunications and energy sectors to deal with these issues. Ofgem required suppliers to put in place an ombudsman scheme following the billing supercomplaint by Energywatch. Under the Consumers, Estate Agents and Redress Act 2000, there will be a statutory requirement for redress schemes in energy and post.

**14** Case studies of consumer problems with switching supplier

**Illustrative example of problems experienced switching energy supplier**

A 79 year old woman approached an energy company in December 2005 to switch both her gas and electricity supply from her current supplier. She was told the switching process would take between four and six weeks. By March 2006, the transfer had still not taken place, with no explanation for the delay. The customer found it difficult to contact the company she was hoping to switch to through either telephone or post.

In March, her former supplier took back the electricity supply claiming they had received 'verbal winback' from the customer's 92 year old husband who was in poor health. The case was only resolved by the intervention of the Citizens' Advice Bureau in September 2006. The customer's former supplier lost the revenue from the verbal winback under the Erroneous Transfer Charter.

**Illustrative example of problems experienced switching telecoms supplier**

A 62 year old telephone customer was persuaded to switch to an alternative supplier by the prospect of cheaper phone calls. He was paying £20–25 per month including line rental with his current supplier and signed up to the alternative supplier's package costing £18 per month for line rental and free weekend calls.

After switching the customer realised he was paying considerably more with the new supplier than he had been with his former company. However, when he phoned the new supplier to cancel his service he was told he had signed an 18 month contract and could not cancel it. The customer had not been told about the 18 month contract during the sale (by telephone) and was not sent any written information.

The new supplier could not trace the original phone call to the customer but believes that the salesperson was well trained and would have mentioned the 18 months contract. The supplier was also sure that written information would have been sent to the customer.

*Source: National Audit Office summary of Citizens' Advice case files*

## Consumers do not always behave as economic theory dictates

**3.16** In addition to providing good quality information and making switching easy, a regulator also needs to understand the diversity of consumer attitudes, experiences and needs.[23] The consumer may not behave in the way that the regulator expects and therefore may not drive competition as expected. For example, 51 per cent of energy customers and 53 per cent of fixed telephony customers surveyed by the National Consumer Council said they would not switch providers even if it was free and simple to do so. This reluctance to switch may be the result of a number of factors, for example:

- Switching, either product or provider, may not be a high enough priority for consumers who are therefore unwilling to spare the time and effort to switch. For example, 22 per cent of consumers gave reasons related to lack of time or too much hassle for not switching fixed telephony provider.[24]
- Consumers may not believe the economic benefits they will gain outweigh the costs involved. National Consumer Council research found that 17 per cent of energy consumers and 21 per cent of fixed line telephony consumers do not expect to make savings from switching supplier.[25]
- Consumers may value other aspects more highly than price and product features such as brand reputation or quality of service. 70 per cent of consumers said they would rather use an established, familiar company than a new company offering a better deal.[26] When Postcomm asked business consumers one thing the mail industry could do differently that would be an improvement for them they received a wider variety of answers. Reduce prices was top but only mentioned by 11 per cent.

## The quality and depth of consumer research by regulators is variable

**3.17** Regulators currently conduct and publish a range of consumer research aimed at understanding the consumer better, for example:

- **Ofcom** – produces an annual report of the consumer experience drawing on data from a number of sources such as a monthly residential communications tracking survey. Where possible, Ofcom attempt to track the research results over time and benchmark against other sectors and countries. Ofcom uses the broader measure of 'participation' in the market rather than just switching and considers past and present behaviour and future intentions.[27] On this basis it segments consumers into inactive, passive, interested and engaged. Ofcom also commissions a variety of other consumer research on an ad-hoc basis, for example in 2007 it conducted a survey into consumer decision making. Its Communications Market Reports also cover consumer experiences to some extent;
- **Postcomm** – produces an annual Business Customer Survey to examine and understand the nature of the business postal market. It also attempts to track trends over time. As well as switching behaviour, Postcomm also asks business consumers if they have used competition to negotiate lower prices – 9 per cent had used this approach. Postcomm also hold individual meetings and consumer events such as road-shows to engage directly with their business consumers as part of a wider stakeholder engagement programme;
- **Ofgem** – analyses switching rates on an ongoing basis including as part of its Domestic Retail Market review. It also produces ad hoc customer research on particular topics – for example, Ofgem has recently carried out research to explore consumer understanding of, and attitudes to, green tariffs as well as the issues facing customers who are in debt. Ofgem carries out quantitative surveys to measure the number of consumers who have switched and analyses this according to a number of variables. These headline figures, often reported in press releases, are likely to be inflated by multiple switchers. Focusing too heavily on switching can lead to distortions in understanding consumer behaviour – for example, it does not take into account the actions and motivations of consumers who do not switch for reasons other than apathy or those that make the wrong choices. Ofgem is currently carrying out a programme of research with consumers to understand their motivations for switching or not switching. Ofgem plan to use the results to segment consumers in a more sophisticated way including behavioural and attitudinal characteristics.[28]

## Regulators could do more to engage with consumers

**3.18** We found that there are areas where regulators could do more to gain better insights through engaging with consumers. To some extent all three regulators already recognise this and are taking steps to improve their information.

**3.19** Ofcom has said it wants to find ever better ways to engage with consumers to better understand consumer interests and preferences, including innovation in the areas of research, consultation and stakeholder engagement. Ofcom received praise from many of the stakeholders we spoke to for its recent progress in doing more to put consumers at the heart of its regulation. Some stakeholders told us they would now like Ofcom to grapple with some more complex consumer issues in-depth, for example improving its understanding of the influence of personal networks on information gathering and decision making.

**3.20** Until recently, Ofgem did not give understanding consumers sufficiently high priority, focusing on building relationships with industry at the expense of consumer representation. Ofgem has recognised it needs to improve its consumer engagement and launched a 'Consumer First' initiative 18 months ago. This began with a review of its performance against best practice. The recommendations from this review, which included building customer insight into the way Ofgem works; improving understanding of the basic demographics of consumers and the deeper issues; and enhancing Ofgem's approach to consultation, are now being implemented.[29] Ofgem has recently appointed an expert in consumer and social research who is tasked with continuing to take the recommendations of the review forward and build consumer insight into the way Ofgem works.

**3.21** Stakeholders in both energy and postal sectors expressed to us a desire for the regulator to become more proactive in understanding and engaging with consumers. Despite Postcomm's programme of consumer events, some stakeholders felt that there was still scope for the regulator to build up a better understanding of business postal consumer needs through more direct interaction with the businesses.

**3.22** From our analysis of consumer research and stakeholder interviews we found the following areas that regulators could consider to improve their consumer understanding:

- **begin from the viewpoint of the consumer** – many consumers will not make decisions about telcomms, energy or post in isolation from other retail and lifestyle decisions. Consumer activity and market regulation could impact on attitudes and behaviour in more than one sector and according to the National Consumer Council, regulation across all sectors might have unintended and adverse consequences for consumers. Regulators could explore the scope for more joint research and outputs – for example Ofgem and Ofcom have both recently carried out research projects into low income consumers;
- **increase their research on actual consumer outcomes** – much of the consumer research we reviewed covered consumer opinions or claimed behaviour. Regulators should explore ways of measuring and understanding actual behaviour and outcomes, for example Ofgem has used mystery shopping to assess the quality of energy efficiency advice given by suppliers, and to rank the level of service given by energy suppliers' call centres;
- **expand their range of methodologies to understand more intangible concepts and engage consumers directly in regulation** – including more qualitative and deliberative research to understand consumer attitudes and behaviours. Ofcom and Ofgem are now using deliberative research and are committed to using more in the future; and
- **follow the lead of the OFT and develop specialist expertise in behavioural economics.** Behavioural economics combines psychology with economics to investigate what happens in markets when humans act on their social, emotional and other biases.

## Vulnerable consumers find it more difficult to benefit from competition

**3.23** A 'vulnerable' consumer is someone who finds it more difficult, due to their particular circumstances, to take advantage of a competitive market. Consumers may be vulnerable for a variety of circumstances, for example economic status, inability to access the internet, physical disability, or a lack of knowledge and understanding. Vulnerable consumers can be protected by competition if those consumers who are active in the market apply competitive pressure across the market as a whole, although this is less applicable if suppliers are able to identify active consumers and offer them better deals which are not available to other consumers. There are a number of protections for vulnerable consumers, such as particular conditions in supplier licences. However, the vulnerable are the least likely to be actively engaged in the market and therefore require particular attention from the regulator.

**3.24** All regulators have recognised that vulnerable consumers in their respective markets have problems not only taking advantage of competition, but sometimes even in paying for and receiving a basic service. They have therefore sought to define 'vulnerable', and to identify and address the particular problems that these consumers face.

**3.25** Ofcom has identified that older customers (age 65+) are less likely to be engaged in the fixed telephony market – that is, more likely to have previously switched and to keep informed of current offers with a view to switching again in the future. Only 6 per cent of over 65's are engaged compared to 20 per cent of consumers overall. In terms of just switching, younger (15-24), older (75+) and consumers in the DE socio-economic group are least likely to have switched supplier – 21 per cent, 26 per cent and 29 per cent respectively compared to 35 per cent overall.[30]

**3.26** Ofgem has identified that consumers in social group E, those aged 65+ and those in rented accommodation are less likely to switch supplier. It has also found that there are historically lower switching rates among pre-payment customers – 36 per cent of gas prepayment consumers compared to 46 per cent gas consumers overall and 41 per cent electricity prepayment consumers compared to 47 per cent electricity consumers overall. This is despite the fact that average savings from switching are greater for pre-payment customers – £100 compared to £60 for direct debit customers. Savings are greater because there is more variation in tariffs between suppliers for consumers on prepayment meters. Although it costs more for industry to provide prepayment meters, the extent to which these costs are passed on to consumers varies. Some suppliers charge prepayment meter customers the same as those on standard charge, while with other providers prepayment customers can end up paying £150 more than direct debit customers.[31]

**3.27** Those on pre-payment meters tend to include consumers on lower incomes and renters. Qualitative research suggests that some pre-payment meter customers have a low awareness of the benefits of switching and limited information on how to switch to the best available deal (for example, through the use of switching websites). Debt blocking, a means of preventing debtors from switching supplier even when the debt has been caused by estimated billing, may also be an issue in some cases. Ofgem intends to carry out further work in this area to gain a better understanding of pre-payment switching behaviour, so that they can take effective action to address any barriers to pre-payment switching. Ofgem are also carrying out a campaign with the Citizens' Advice Bureau to raise awareness amongst advice workers of the savings that can be made by switching energy supplier and how their clients can go about getting the best deal.

**3.28** A 'vulnerable' consumer in post is a difficult concept for Postcomm to define in the context of this report which mainly addresses business consumers using Special Delivery (Next Day). Postcomm differentiates between vulnerable consumers and 'captive' consumers; businesses which are too small to take advantage of competition. Companies which are dependent on the postal system for their business are likely to feel a more negative impact from poor service or an inefficient market. On the other hand, companies with smaller mailing volumes are less able to take advantage of competition and are likely to have less knowledge and understanding of their mailing options – only 3 per cent of small mailers plan to move some of their mail from Royal Mail compared to almost 20 per cent for large mailers.[32]

**3.29** In both energy and fixed telephony, the regulators' research shows that older people and those in social group E are least likely to switch supplier. This suggests there is scope for Ofgem and Ofcom to work together to understand the wider context in which consumers in these groups operate and how this influences their engagement and behaviour in both the energy and fixed telephony markets.

# PART FOUR

# Did the regulators take the right steps in removing retail price controls?

**4.1** When removing price controls regulators need to evaluate the potential for effective competition to develop. To do this effectively a regulator needs to collect and analyse suitable evidence, both qualitative and quantitative; consider the options which might bring about the desired changes in markets or behaviour; and consult widely, taking on board comments where necessary. This Part looks at how well Postcomm, Ofcom and Ofgem undertook these activities.

**4.2** We found that the decision making process is complex, requires the regulator to make judgments about the prospects for competition to develop in the future, and depends on both the quality and availability of quantitative and qualitative data. All of the regulators in our study followed the expected process of gathering evidence, appraising options, consulting widely and reaching a decision. However, this masks differences in the approach of each regulator due to differences in the evidence and data available at the time of the evaluation.

- Ofcom and Ofgem gathered substantial bodies of quantitative data to assess the strength of competition. They set indicators and used the movement in these indicators to determine whether competition was developing, rather than measurable criteria.
- Postcomm did not have access to the same level or quality of quantitative data as Ofcom or Ofgem, largely due to the lack of data from suppliers other than Royal Mail. It therefore set specific criteria to measure the strength of competition and used much qualitative information in its evaluation. It also concentrated on building a consensus in the industry as to the likelihood of a competitive market developing.
- All of the regulators presented several options and consulted widely on them, Postcomm made changes to its preferred course of action and Ofgem delayed implementation by a year as a result of these consultations.

Detailed case studies covering the removal of the price control in each sector are given at appendices 3, 4 and 5.

## The regulators took different approaches to setting criteria and collecting data

**4.3** Robust and transparent decision making requires that regulators are able to defend their decisions. One way of doing this is to set out the conditions which need to be met before a course of action, such as removing price controls, is considered. The three regulators in our study took different approaches to this. Postcomm set out specific criteria against which to measure the strength of competition. In contrast, Ofgem and Ofcom made use of general trends in their data to indicate the development of competition; but without setting specific levels at which competition would be considered to have developed.

### Postcomm established criteria to assess the strength of competition for postal services

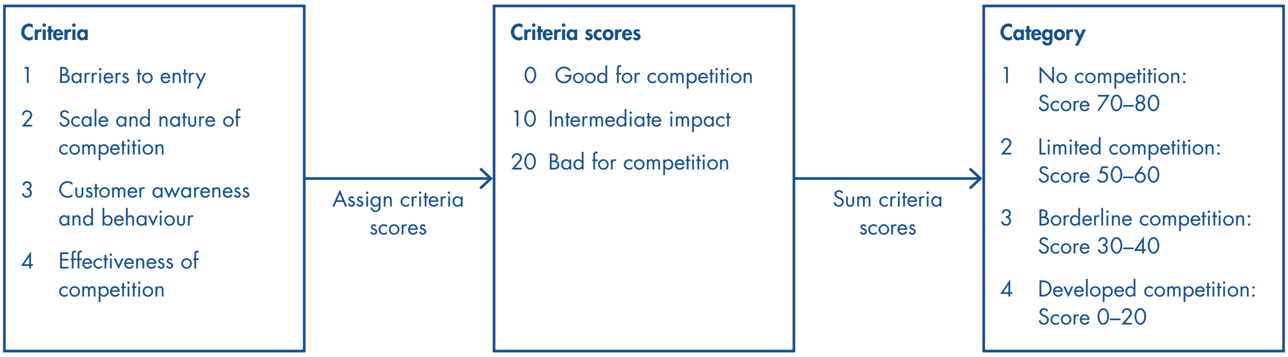
**4.4** Postcomm's consultants advised using four criteria against which it scored the development of competition: barriers to entry; scale and nature of competition; customer awareness and behaviour; and effectiveness of competition. Each criterion was scored on a scale of zero, ten and twenty, representing good for competition, intermediate impact and bad for competition **(Figure 15 overleaf)**.

## Postcomm's analysis of competition was hindered by the limited availability of quantitative data

**4.5** Despite identifying specific criteria, Postcomm's analysis was hindered by the limited amount of data it was able to collect on the market for Special Delivery (Next Day) type products. This is in part due to difficulties in collecting information when many of the competing suppliers are under no obligation to provide it because it falls outside their licensed activities.

**4.6** Postcomm's analysis of the markets for Presstream[33] and Special Delivery (Next Day) resulted in scores of 40, meaning that it considered that competition had developed enough to remove the price control **(Figure 16)**. However, the way that scores were allocated to each criterion were relatively subjective due to the lack of quantitative data. Further details on the scoring process can be found at Appendix 5.

**15** Postcomm's criteria model for assessing the development of competition




*Source: Postcomm*

**16** Analysis of competition for Special Delivery (Next Day) and Presstream

| | Special Delivery | | Presstream | |
|---|---|---|---|---|
| Criterion | Comment | Score | Comment | Score |
| Barriers to entry | Barriers not high, except for VAT privilege.[1] | 10 | Low barriers to entry. Significant proportion of customers expected to be able to reclaim VAT. | 0 |
| Scale and nature of competition | Similar services are available to businesses, but not domestic users. | 10 | No major competitors offering similar service at present. | 10 |
| Customer awareness and behaviour | Business customers would be expected to switch. | 10 | Little evidence of switching, but expectation that publishers are aware of prices/ alternative offerings. | 10 |
| Effectiveness of competition | Competition reasonably effective for large businesses but not households. | 10 | Not considered to be effective, as no alternative suppliers. | 20 |
| **Overall Scores** | | **40** | | **40** |

*Source: Postcomm*

NOTE

1 Royal Mail does not charge VAT on postal services, yet other postal operators are required to charge VAT at 17.5 per cent. While this has little effect on businesses that can reclaim VAT, many major mailers – such as providers of financial services and charities – are not able to reclaim VAT and this puts competitors to Royal Mail at a disadvantage.

## Ofgem and Ofcom were able to gather and analyse substantial bodies of quantitative data across a range of measures

**4.7** In contrast to Postcomm, Ofcom and Ofgem collected far greater amounts of quantitative data. Ofcom and Ofgem used their professional judgement to balance a range of measures rather then setting a specific score to demonstrate the strength of competition. The approach used by Ofcom and Ofgem required some degree of calculated risk to balance any conflicting messages the data may provide. The key measures used by Ofgem and Ofcom are shown in **Figure 17 and Figure 18 overleaf** and, in their opinion, demonstrated that competition was developing.

**4.8** Both Ofcom and Ofgem relied on the direction of movement in these indicators to demonstrate that competition had developed to a level where they could remove retail price controls. However, inconsistencies in the direction of movement in key metrics demonstrate the need for regulators to balance the relative importance of different indicators. In such cases they must take calculated risks which draw upon their professional judgement. For example, in the energy sector, the direction of change in the number of firms entering and exiting the market could indicate that there are still barriers to entry and difficulties preventing new entrants from competing effectively. This suggests a need for regulators to ensure that their strategy for the market post removal needs to reflect their analysis of it pre-removal.

**17** The key metrics used by Ofgem when removing retail price controls

| Indicator | Meaning | Direction of Indicator | Commentary |
|---|---|---|---|
| Net switching away from BGT and regional electricity monopoly suppliers | The net switching rate is important as this represents the number of consumers switching from the incumbent ex-monopoly supplier to a new entrant. | Up | Ofgem's analysis showed that some six million customers had switched away from BGT between July 1996 and April 2001; in electricity some 12 million customers switched between September 1998 and September 2001. |
| Market share data of BGT and ex-Public Electricity Suppliers | This represents the market share of ex-monopoly suppliers; a fall in these figures means that new entrants are gaining market share and increasing competition. | Down | BGT's market share fell from 84 per cent in September 1998 to 67 per cent in September 2001. Electricity customers supplied by ex-monopolies 'in-area' fell from an average of 90 per cent to 70 per cent between September 1999 and September 2001. |
| Market entry | As firms enter the market this should lead to greater pressures on suppliers to price more competitively, to improve their quality of service and to innovate. | Up | Between 1995 and 2000 there were six new small scale domestic entrants. Four were subsequently purchased by the existing suppliers. Suppliers that had an incumbent area also entered regions that they did not previously have access to. |
| Market exit | As firms leave the market there will be less pressure on those that remain to act competitively. | Up | The number of active gas shippers and suppliers had both fallen by two between 2000 and 2001. The number of active electricity suppliers had fallen by one and three, in England and Scotland, respectively. The number of offers available to consumers had also fallen, reflecting in Ofgem's opinion, the decreased number of competitors. |

*Source: Ofgem*

**18** Key metrics used by Ofcom

| Ofcom | Meaning | Direction of Indicator | Commentary |
|---|---|---|---|
| The take-up of residential wholesale line rental (WLR) | WLR is a product that BT is obliged to provide to other communications providers, enabling them to offer branded line rental and calls to customers, using BT's local network. | Up | The number of customers using WLR rose from zero in Q1 2004 to two million in Q2 2006.<br><br>Ofcom determined that the WLR product was fit for purpose as at 31 December 2005. |
| The take-up of carrier pre-selection (CPS) | CPS allows customers to choose which telecoms provider carries their voice calls. | Up | The volume of customers using CPS rose from zero in late 2001 to around 4.5 million in early 2006. |
| BT's market share | BT is by far the largest player in the market, with a market share substantially greater than all other fixed line operators combined. | Down | BT's share of the market for fixed calls has been falling steadily since 2002. For example, BT lost 11 per cent of its market share of fixed line national calls by volume between Q4 2002 and Q4 2005. |
| Rates and ease of switching | Switching between suppliers to take advantage of lower prices is an indication that competition is developing. The easier this process, the more likely it is that customers will respond to price differences by changing supplier. | Up | 28 per cent of consumers had switched their fixed line supplier; 23 per cent had switched their landline calls supplier; 10 per cent of landline customers had switched both their line rental and calls supplier.<br><br>91 per cent of those that had switched their landline supplier rated it as very/ fairly easy. 66 per cent who had never switched landline supplier perceived it to be very/fairly easy. |
| Awareness of suppliers | For switching between suppliers to occur requires consumers to be aware of alternatives to their current supplier. | Up | Ofcom research indicated that there was relatively high awareness of alternative fixed line suppliers among consumers: when prompted, 97 per cent of consumers were aware of at least one alternative supplier. |
| Residential call costs | The costs of calls could be expected to fall as suppliers compete for business. | Down | Overall, there is a trend towards lower real costs for the fixed line component of the residential bundle of services. |

*Source: Ofgem*

## Regulators consulted widely on the options for regulation

**4.9** Once regulators have made an assessment of the strength of competition they must then consider how they will respond. They have a range of regulatory options available, such as retaining controls, completely removing controls, partially removing controls or removing them but with certain assurances. Considering a range of options and their expected impacts allows regulators to demonstrate clearly the reason for their choice of preferred option, and why other options have been rejected.

## The regulators in our study presented several options during the consultation phase

**4.10** We found that all the regulators in our study presented options for removing products from price controls or continuing with existing or modified arrangements. The preferred options and the alternatives proposed are summarised in **Figure 19**.

**19** Presentation of options and their development

| | | |
|---|---|---|
| **Ofcom** | **Regulation from 2006** | **Preferred option**<br>■ No price control, but BT gives voluntary assurances for vulnerable consumers, combined with creation of Openreach [Figure 5].<br>**Other options considered**<br>■ No regulation in place of retail price control;<br>■ Roll-over of the existing retail price control; and<br>■ Safeguard cap on the entry level BT tariff. |
| **Ofgem** | **Price control from April 2000** | **Preferred control**<br>■ Remove direct debit customers from the control<br>**Other options considered**<br>■ Price caps should continue to apply to PromptPay, Standard Credit and Prepayment Meter tariffs |
| | **Price control from April 2001** | **Preferred option**<br>■ Price caps should be removed from PromptPay and Standard Credit; and<br>■ relative price caps on the prepayment meter tariff. |
| | **Regulation from April 2002** | **Preferred option**<br>■ Replace price control regulation with the use of powers of investigation and enforcement under competition law.<br>**Other options considered**<br>■ Retain existing relative price control for BGT and revise ex-Public Electricity Suppliers' price restraints; Retain existing relative price control for BGT and introduce relative price caps for ex-Public Electricity Suppliers |
| **Postcomm** | **Special Delivery (Next Day) from March 2006** | **Preferred control**<br>■ Removal of Special Delivery (Next Day – for business account users) from the Price Control<br>**Other options considered**<br>■ Retention of Special Delivery (Next Day) in the Price Control but regulated by a number of sub-controls. |
| | **Presstream from March 2006** | **Preferred**<br>■ Retention of Presstream 1 and 2 in the Price Control<br>**Other options considered**<br>■ Removal of Presstream 1 and 2 from the Price Control; and<br>■ removal of Presstream 2 |

*Source: National Audit Office*

## Postcomm, Ofcom and Ofgem all consulted widely on their options

**4.11** Postcomm and Ofcom undertook lengthy consultation exercises; and in Ofgem's case it undertook several consultations during the course of removing retail price controls. Postcomm's consultation led directly to changes in its preferred option for dealing with Presstream. For example, in the June 2005 proposals the preferred option was to remove Presstream 1 and 2 from the scope of the price control. However, both Presstream products were retained within the price control as part of the final Royal Mail licence modification. Ofgem delayed removal of the price controls by a year as it was not satisfied with progress. In contrast, the preferred option presented by Ofcom was not changed as a result of consultation.

**4.12** Consultations can lead to a range of views being expressed: consumer groups had reservations about the state of competition in the energy and telecoms markets, and considered that competition had not developed sufficiently to protect consumers; suppliers were more supportive of controls being removed, as they considered that price controls were holding back the further development of competition. In such circumstances it is important for regulators to use their judgement to weight/balance these conflicting views against the overall objectives of the regulations.

**4.13** We consulted widely with industry stakeholders about the consultation and decision making processes used by their respective sectoral regulators. Most stakeholders in the energy and telecoms sectors were generally supportive of the processes undertaken by Ofgem and Ofcom. They also considered that the price controls were probably removed at an appropriate time. Several stakeholders in the postal sector, however, expressed greater concern about the timing of the decision and a lack of transparency in the process.

# APPENDIX ONE

# Methodology

## Study rationale

**1** During the 1980's the then Government privatised as monopolies the state owned providers of gas, electricity, telecoms and water. To protect consumers from monopolistic practices, such as uncompetitive pricing and underinvestment in assets, the Government created economic regulators. The regulators were tasked with setting price limits to ensure adequate investment by the monopolies and fair prices for consumers, and promoting competition where appropriate. Similar regulatory arrangements were established in the postal industry due to the dominance of Royal Mail with Postcomm being established as the postal services regulator in 2001.

**2** Nearly twenty years on from privatisation the experience of price setting and competition varies across the different sectors. Regulators have introduced competition in some areas of utilities provision and moved away from a reliance on retail price controls, allowing the market to set prices.

## Study Scope and Audit Criteria

**3** We examined the three regulators that have removed retail price controls – Ofcom has removed the BT price control on fixed line telephony; Ofgem has removed price controls for domestic gas and electricity supply; and Postcomm has removed the price control on Special Delivery (Next Day – for business and account users).

**4** The removal of price controls will represent value for money if consumers are protected by competition and have the potential to benefit from it. Value for money in this context means:

- whether regulators monitor markets to ensure that effective competition is developing;
- whether regulators have enabled consumers to take advantage of competition; and
- whether regulators took the right steps when removing retail price controls.

We have evaluated regulators' approaches against these three areas to determine value for money.

## Methodology

**5** The key elements of our study methodology are set out below:

### Case Studies of the Removal of Price Controls (Appendices 3, 4, and 5)

**6** We used Case Studies from each regulator to compare the approaches used to remove price controls. We undertook a desk-based review of the consultation documents, the analysis of costs and benefits, the evidence used to support the decision, and how the decision was influenced by the consultation process. We followed up our desk-based review by interviewing those involved at the regulators, such as economists and policy makers.

### Multi-Criteria Analysis

**7** Multi-criteria analysis is a technique that seeks to take account of multiple, conflicting criteria in the process of monitoring the impact of decisions and informing further intervention. We used this technique to identify a range of inter-related metrics and criteria that regulators use to monitor the effectiveness of removing price controls. We involved representatives from the regulators to identify the criteria and metrics currently used to monitor the market.

## Economic Analysis (Appendix 6)

**8** We commissioned Europe Economics to analyse the data that regulators use to monitor markets and inform their decision making. Europe Economics also collected data on the metrics identified during the development of the Multi-Criteria analysis and advised on the types of data which they considered would be useful to regulators.

## Semi-structured interviews

**9** We used semi-structured interviews to establish the views of the following key stakeholders:

- **Regulators** – We interviewed members of staff within Ofcom, Ofgem and Postcomm to establish the principles on which they base their decision-making; the strategies for removing controls where they still exist; and how efficient markets are maintained.
- **Operators and Trade Fora** – We met representatives of regulated companies to establish their views on: the process used by their regulator to remove the price control; how they have made it easier for consumers to benefit from competition; and how they monitor the state of the market.
- **Consumer Bodies** – We met several consumer bodies and also reviewed their relevant research.

The list of list those interviewed during our review is shown in **Figure 20**.

## Literature review

**10** We reviewed research from the regulators, consumer groups, academia and other sources on consumer behaviour, the development of competition and the removal of price controls in the regulated utilities sector.

## Expert Panel

**11** We convened an expert panel to provide advice during the course of our review. The panel comprised:

- **Phil Evans:** He is currently a Director of Fipra, a company specialising in European public affairs. Prior to this he spent almost a decade at Consumers' Association and six years at the Economist Intelligence Unit. He has written a number of books, contributed chapters and authored papers on subjects ranging from shopping to intellectual property. He has taught at a number of universities and is an economist by training.
- **Nick Fincham:** He is currently Director, Economic Regulation & Competition Policy at the Civil Aviation Authority. Over the past 15 years he has held senior positions at a number of UK regulators (OFFER, Ofgas, Ofgem, Postcomm and the Civil Aviation Authority). More recently, he set up a consultancy company – Black Island Consultancy – to provide economic and strategic advice to UK regulatory bodies.

**20** Bodies interviewed by the NAO

| Energy sector | Telecoms sector | Postal sector | Consumer bodies and other stakeholders |
|---|---|---|---|
| EDF | BT | TNT | National Consumer Council |
| E.On | T-Mobile | Citipost | Ofcom Consumer Panel |
| RWE | Cable & Wireless | Royal Mail | Energywatch |
| Scottish Power | Carphone Warehouse | Mail Competition Forum | Postwatch |
| | | Periodical Publishers Association | Centre for Competition Policy, University of East Anglia |

*Source: National Audit Office*

APPENDIX TWO

# Background to retail price controls

## Background to the issue

**1** Price regulation is designed to protect consumers from a lack of effective competition, so that firms with market power cannot abuse their position to the detriment of consumers and the development of competition. It is also used to protect consumers in those instances where competition is not sufficient to ensure the best deal for consumers or properly to protect consumers. The National Audit Office previously reported on the risks to price control regulation.[33] This report covered the monopoly networks of the utility providers.

**2** Retail price control regulation is designed to protect the consumer from excessive increases in prices while providing companies with incentives to reduce costs and improve services. The model generally followed in the UK places a cap on the revenue or prices that ex-monopolies are allowed to generate or impose. **Figure 21** gives details of retail price controls in the telecoms, postal and domestic energy sectors.

**21** The coverage of retail price controls in telecoms, energy and post

**BT:** The retail price control was introduced in 1984 and covered the price of a basket of residential retail telephony services: local national and international calls, calls to mobiles, operator assisted calls and exchange line rental. The retail price control applied to the expenditure on these services of the lower 80 per cent of BT's residential customers by spend.

**British Gas and 14 Public Electricity Suppliers:** In the gas market, the original price control applied to BGT allowed for the pass-through of gas purchase costs to the end consumer and also controlled the supply costs. In the electricity market, the ex-Public Electricity Suppliers' (PES) 'in area' prices were subject to price restraints, which capped the average price charged for electricity supplies to domestic customers.

**Royal Mail:** Royal Mail is required to operate within a 'pricing framework' on two baskets of goods defined in Condition 21 of its Licence. The detail of the pricing framework and the products contained within it are subject to periodic review.

*Source: National Audit Office*

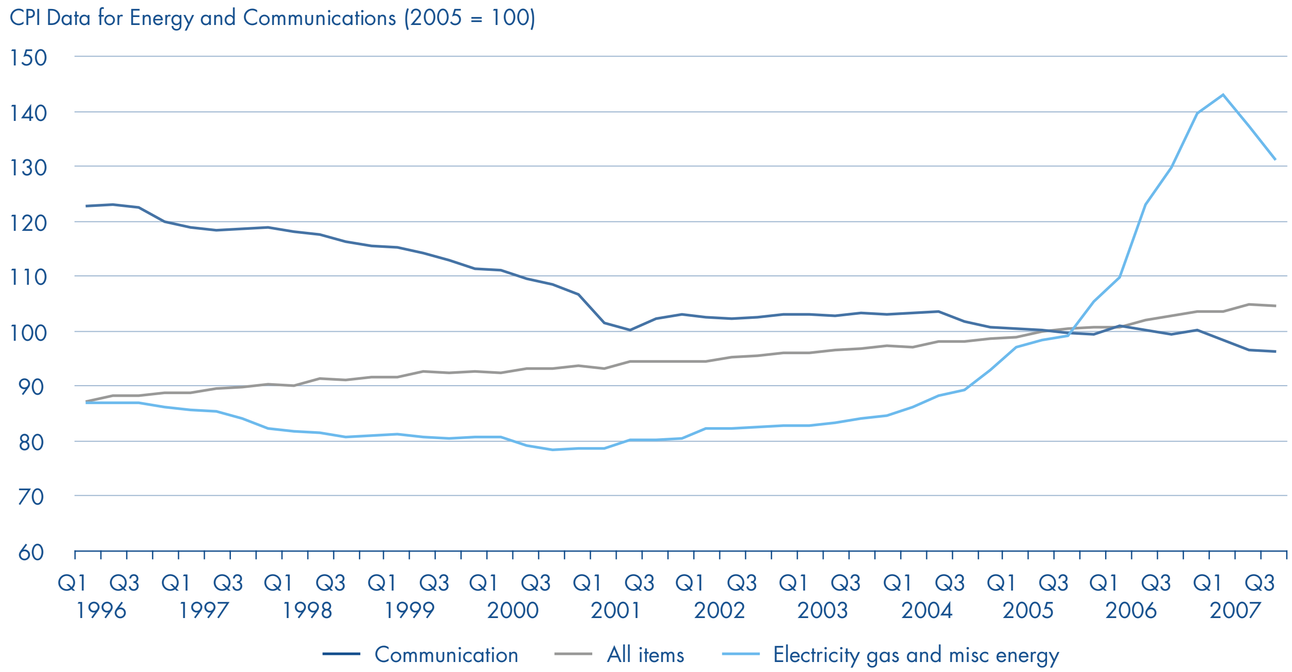
**3** Nominal prices for energy have increased significantly faster than the Consumer Prices Index, whereas in the telecoms sector nominal price increases have been below CPI (Figure 22). Relative price falls in the cost of telecoms is likely to be the result of technological factors, whereas in energy the price is influenced more by wholesale costs. **Figure 22 overleaf** covers the end prices to consumers and therefore includes those elements that are still subject to price regulation such as distribution and transmission costs in energy.

## Statutory Objectives of Regulators

**4** The statutory objectives of the three regulators under review all task them with introducing competition where appropriate. Ofgem's principal statutory objective (Energy Act 2004) is to protect the interests of gas and electricity customers, present and future, wherever appropriate by promoting effective competition. Ofcom's principal duty is to further the interests of citizens in relation to communication matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition (Communications Act 2003). Postcomm must exercise its functions in a manner that it considers is best calculated to ensure the provision of a universal service. Postcomm must also act in the way that it considers is best calculated to further the interests of users of postal services, wherever appropriate by promoting effective competition between postal operators.

**5** In order to introduce competition the regulators have powers to deter the abuse of market power by dominant suppliers. This includes deciding at what stage they can remove the price control from the existing incumbent.

**22** Nominal price increases in energy and communications




*Source: Office of National Statistics*

**6** The regulator must also decide what level of regulatory intervention is appropriate and therefore on the model of regulation to adopt and the most proportionate response. In deciding which is the most appropriate form of regulation the regulator must balance several factors, including, the vulnerability of consumers, the potential/likelihood of market abuse and the burdens that might be placed upon business.

**7** By applying the minimum level of regulatory oversight necessary to achieve their goals, regulators can balance the need to protect consumers with the need to enhance competition and consumer choice.

APPENDIX THREE

# Ofcom Case Study – removal of BT's fixed line price control

## Introduction

**1** Ofcom allowed the retail price control to lapse in August 2006, allowing the market, rather than regulation, to determine the price of services. The retail price control had been in place since 1984, (the year BT was privatised), with the aim of securing year-on-year price falls in a market which at the time did not have sufficient competitiveness to force prices down.

**2** The retail price control regulated the price of a basket of retail telephony services: local and national calls, operator assisted calls and exchange line rental. The control was set at RPI+0%, meaning that BT could not increase charges for the basket of services in real terms (i.e. overall retail prices could not go up by more than RPI).

**3** A key element in allowing the removal of retail price controls was ensuring that the structure of the telecoms industry could support competition at a retail level. In order to facilitate this Ofcom undertook a lengthy process to understand the dynamics of the market and then proposed a structural solution, known as BT Openreach. There were several key stages in the decision making process, shown in **Figure 23**.

**4** Ofcom took a staged approach to the removal of retail price controls. It firstly undertook a Strategic Review of Telecommunications to examine the then position and prospects of the telecoms sector. Ofcom stated that this review would be comprehensive, wide-ranging and evidence-based. It wanted to shape its strategy through which it would promote competition or take other regulatory action to further the interests of consumers. Phase 1 of the Review identified two main problems which would need to be tackled before Ofcom could consider the removal of the retail price control:

- domination of the market by BT, the incumbent, with alternative providers that were, in the main, fragmented and of limited scale; and
- overly complex regulation which in many areas was dependent on intrusive micro-management to achieve its purposes, and which failed to address core issues of BT's control of the UK-wide access network.

**5** In Phase 2 of the Strategic Review Ofcom identified, presented and assessed the options for addressing the key issues identified in the previous Phase. The three options presented by Ofcom were as follows:

- Option 1 – Full deregulation
- Option 2 – An investigation under the Enterprise Act
- Option 3 – BT to deliver equality of access

**23** Timeline of key stages in the removal of BT's fixed line price control

| | |
|---|---|
| **Dec 2003** | Ofcom announces that it will be consulting throughout 2004 on a Strategic Review of Telecoms |
| **Apr 2004** | Strategic Review of Telecoms 'Phase 1 Consultation' published |
| **Nov 2004** | Strategic Review of Telecoms 'Phase 2 Consultation' published |
| **Jun 2005** | Consultation on the 'Undertakings' offered by BT |
| **Sep 2005** | Final Statements on the Strategic Review and Undertakings in Lieu of a Reference under the Enterprise Act published |
| **Sep 2005** | BT Undertakings take effect |
| **Mar 2006** | Consultation on retail price controls published |
| **May 2006** | Deadline for responses to consultation |
| **July 2006** | Final Explanatory Statements published |
| **Aug 2006** | Retail price control expires |

*Source: Ofgem*

**6** A key stumbling block to the removal of the retail price control was seen to be the structure of BT, which could allow it to favour its own retail operations above those of competitors. This would hamper the development of competition and ensure the continuation of a regime of retail price controls. BT proposed the creation of 'Openreach', a restructuring of its operations aimed at stimulating competition and innovation. Openreach would ensure that all telecoms operators would have fair and equal access to BT's infrastructure.

**7** Ofcom consulted on BT's proposals for the creation of Openreach as part of a third consultation phase. In September 2005, Ofcom accepted undertakings from BT that required it to provide various wholesale products at a standard known as "equivalence of inputs" (EoI). By this standard, BT is obliged to use the same wholesale products and services itself as it provides to other communications providers. Openreach was launched in January 2006 – it owns and manages all the wires, cables, underground ducts and poles that connect users to their local BT telephone exchange and the national phone network. The company is responsible for delivering equivalent access to the services associated with the 'first mile' of wires which run between a customer's premises and the local BT exchange (the 'local loop'). In the past the network was managed by both BT Retail and BT Wholesale, but the engineers concerned have been brought together under one organisation to guarantee that all communications providers will be treated equally.

## Removal of the retail price control – rationale

**8** Ofcom had several objectives it wanted to achieve in allowing the retail price controls to lapse. It wanted to operate with a bias against intervention and where it does intervene to do so by the least intrusive regulatory means; to facilitate effective retail competition; and to mitigate risks to low spending consumers. Ofcom considered that allowing the retail price control to lapse and agreeing voluntary undertakings with BT would achieve all of these aims.

## Consultation

**9** In March 2006 Ofcom consulted on the removal of retail price controls, with voluntary assurances from BT. There were four options, as follows:

### Option 1 – No regulation in place of retail price control

**10** No regulation would be consistent with one of Ofcom's key regulatory principles to operate with a bias against intervention. Not imposing any regulation in place of the retail price control upon its expiry would be consistent with this objective. However, concerns about low spending consumers falling outside the protections afforded by the social telephony tariffs led Ofcom to conclude that it would be premature not to impose any controls, lacking assurances from BT to address ongoing concerns raised by its continued 'significant market power'.

### Option 2 – Roll over of the existing retail price control

**11** Ofcom considered rolling over the existing price control, either until it had further evidence on the sustainability of competition or until completion of the 2007 market review.

**12** Rolling over the retail price control would continue to protect the lowest spending 80 per cent of consumers. However, Ofcom considered this could be unduly burdensome and disproportionate, and conflict with its regulatory principles. Furthermore, Ofcom considered that a roll-over of the retail price control arrangement may have an adverse impact on consumers if, in response to competition, BT reduced prices for calls, but increased exchange line charges. This would disproportionately impact on lower spending consumers.

### Option 3 – Safeguard cap on the entry level BT tariff

**13** Ofcom could have sought to modify the price control by imposing safeguard caps only on certain tariff packages. Such an approach would target those products where concerns over the exploitation of market power are most significant. However, Ofcom considered that the voluntary assurances offered by BT could provide a similar level of protection as retaining a price control but would be less intrusive.

### Option 4 – No control but BT gives voluntary assurances

**14** Ofcom also considered allowing the existing retail price controls on all residential call services to expire, but also to seek assurances from BT to provide additional protection for low spending consumers not protected by BT's Universal Service Obligation. Ofcom identified these consumers as being most vulnerable once the price control was removed. This was Ofcom's preferred option.

## The evidence used to make a decision

**15** Ofcom presented some robust quantitative evidence in support of its preferred option. The Strategic Review had demonstrated that competition was well developed in the telecoms sector, with competition from other telecom suppliers and some substitutable products providing a downward pressure on prices.

**16** The key evidence used by Ofcom to demonstrate that the market for fixed telecoms was competitive was as follows:

**A** An increase in the take up of wholesale line rental (WLR);

**B** An increase in the use of Carrier Pre-Selection (CPS) for calls;

**C** Changes in BT's market share;

**D** The rates and ease of switching; and

**E** Falling profitability ratios.

### A: Wholesale Line Rental (WLR)

**17** 'Wholesale Line Rental' (WLR) is a product that BT is obliged to provide to other communication providers. It enables them to offer both line rental and calls to end-users over BT's local network. The March 2006 consultation indicated that there were one million consumers using WLR at the end of 2005 suggesting an increasing competitive pressure on BT's position in the market. **Figure 24** shows the rapid take-up of residential WLR lines, from close to zero in early 2004 to nearly two million by the end of June 2006.

### B: Carrier Pre-Selection

**18** Carrier Pre-Selection (CPS) is a mechanism which allows users to select alternative operators in advance without dialling additional codes on the telephone. The customer subscribes to the services of one or more CPS operators and chooses the type of calls that will be routed through the alternative operator. **Figure 25 overleaf** shows that the volume of customers with CPS increased from zero in late 2001 to around 4.5 million in early 2006 placing pressure on BT to keep its prices competitive.

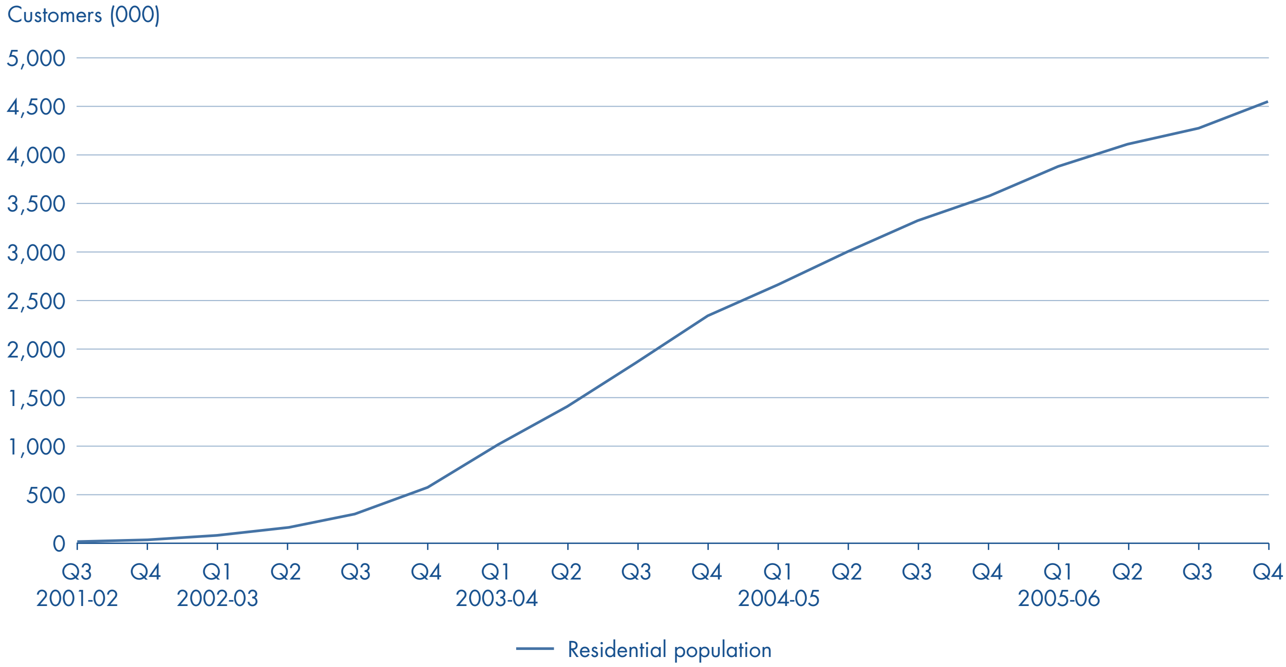
### C: BT's Market Share

**19** BT's market share of residential fixed line calls, by volume and value, had been steadily declining since the introduction of the price control in 2002. For example, BT lost 11 per cent of its market share of fixed line national calls by volume between Q4 2002 and Q4 2005 **(Figure 26 overleaf)**. This decline was repeated across local calls, calls to mobiles and international calls.

**24** Residential Wholesale Line Rental take-up


*Source: Ofgem*

**25** Carrier Pre-selection residential customer volumes




*Source: Ofgem*

**26** BT's market share by volume and value, Q3 2002 to Q4 2005

| | | Q3 2002 (%) | Q4 2005 (%) | Decline (%) |
|---|---|---|---|---|
| Residential analogue exchange lines | Volume | 83 | 77 | 6 |
| Local calls | Volume | 77 | 56 | 21 |
| | Value | 70 | 63 | 7 |
| National calls | Volume | 70 | 59 | 11 |
| | Value | 73 | 54 | 19 |
| International calls (see note) | Volume | 53 | 44 | 9 |
| | Value | 67 | 56 | 11 |
| Calls to mobiles | Volume | 75 | 60 | 15 |
| | Value | 71 | 53 | 16 |

*Source: Ofgem*

NOTE

A greater market share by value than volume may suggest higher pricing by BT, but it could equally be consistent with BT serving a larger proportion of higher value routes.

## D: Rates and Ease of Switching

**20** Ofcom took into account the evidence of consumers switching between suppliers. Ofcom's research found that there was relatively high awareness of alternative fixed line suppliers among consumers: 92 per cent were aware without prompting of at least one competing supplier. When prompted with a list of alternatives, awareness of at least one alternative supplier rose to 97 per cent, with 21 per cent able to recognise three or more alternatives **(Figure 27)**.

## E: Pricing and Profitability

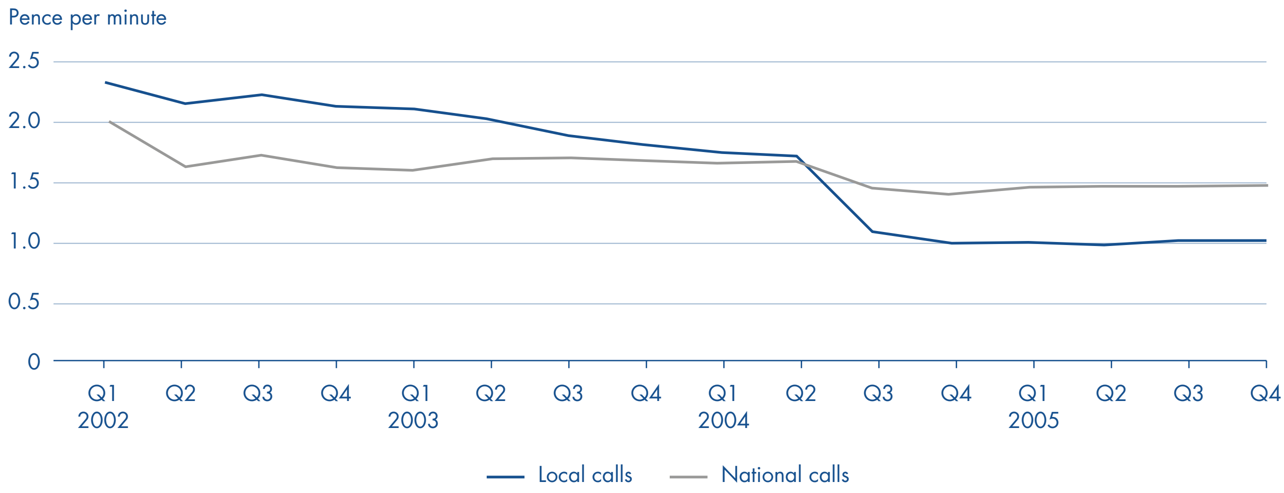
**21** Ofcom took into account the extent to which BT had pricing freedom due to its market power and examined whether excessive returns were being made. The analysis showed how call prices were falling and that BT's average revenue per call had also declined **(Figure 28 and Figure 29 overleaf)**. Ofcom concluded that this demonstrated the presence of competitive pressures which should restrain the ability of BT to raise its prices.

**27** Awareness of competing landline suppliers

| | 0 Suppliers (%) | 1 Supplier (%) | 2 Suppliers (%) | 3 or more suppliers (%) | Don't know (%) |
|---|---|---|---|---|---|
| Spontaneous | 7 | 56 | 30 | 6 | 1 |
| Prompted | 3 | 34 | 42 | 21 | 0 |

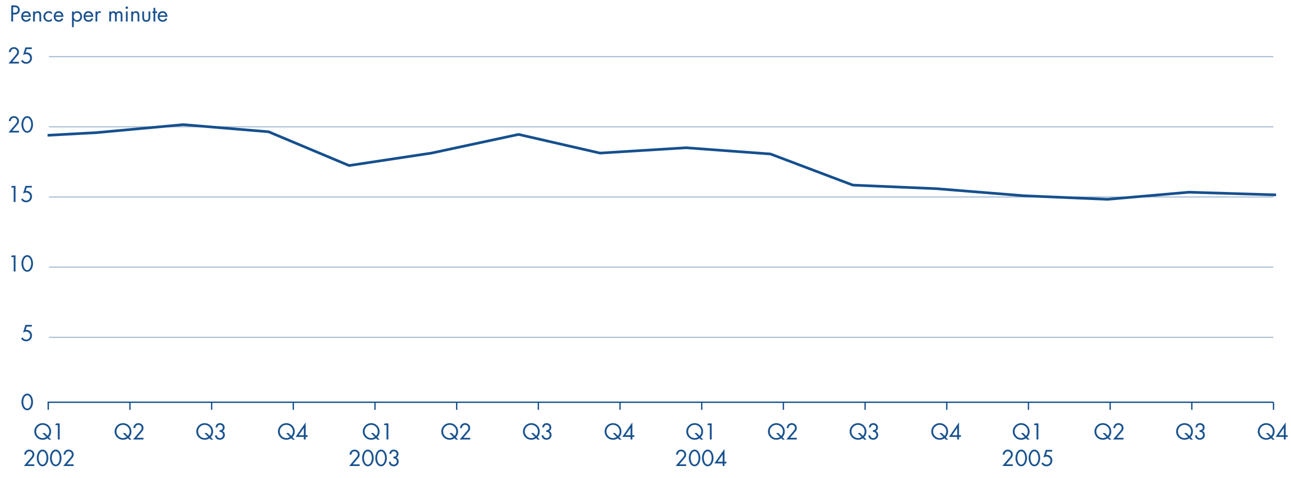
*Source: Ofcom*

**28** Residential local and national average call revenues (pence per minute)




*Source: Ofcom/BT*

**29** Residential international average call revenues (pence per minute)




*Source: Ofcom/BT*

## Consultation responses

**22** A range of responses was received to the March 2006 Consultation. Many of the responses, including those from BT, the Scottish Executive, the Welsh Assembly Government and the Communication Workers Union, provided support for Ofcom's proposal. Industry respondents acknowledged that there had been significant developments in both wholesale and retail markets since the retail price control was imposed in 2002, but in general, they favoured delaying deregulation until after the delivery of 'Equivalence of Input' (EoI). Citizens Advice Bureau considered that the retail price control should only be removed if two conditions could be met: sufficient and durable protections for low spending consumers not covered by social telephony schemes; and all groups of consumers to be not only aware of their ability to switch but confident of exercising this choice.

**23** Following its consultation exercise, Ofcom decided to chose option 4 – its original preferred option. It considered that the interests of consumers would be best served by their growing awareness of the choices available through competition and with the increased competition bought about by the changes in wholesale regulation with the creation of 'Equivalence of Input'. Ofcom considered that this should in turn lead to new services, greater choice, and further reductions in retail prices.

# APPENDIX FOUR

# Ofgem Case Study – the removal of the retail price controls (1998 to 2002)

**1** This section reviews Ofgem's process for deciding to allow all retail price controls for domestic gas and electricity supply to lapse from 1 April 2002. The key dates in the removal of retail price controls are shown in **Figure 30**.

## Ofgem's objectives from the removal of retail price controls

**2** Under Section 4 of the Gas Act 1986 (as amended), the Gas and Electricity Markets Authority has the principal objective to protect the interests of consumers, both existing and future, in relation to gas conveyed through pipes, wherever appropriate by promoting effective competition.

**30** Key dates in the development of competition in the domestic energy market

| | |
|---|---|
| 1986 | British Gas privatised |
| 1989 | Regional Public Electricity Suppliers (PES) privatised |
| Apr 1996 | Domestic gas customers able to switch for the first time |
| Feb 1997 | British Gas plc de-merged into BG and Centrica |
| May 1998 | Domestic gas market fully opened to competition |
| Sep 1998 | Domestic electricity customers able to switch for the first time (Centrica starts to supply electricity). |
| May 1999 | All PES supply areas fully opened to competition for domestic electricity. |
| Apr 2000 | Direct Debit customers removed from the control, but price controls remained on PPM, Standard Credit and Prompt Pay tariffs. |
| Apr 2001 | Centrica's April 2000 price caps removed, except for relative price limits on pre-payment meters. |
| Apr 2002 | All price controls lifted on gas and electricity. |

*Source: Ofgem*

In performing these duties, the Authority should have regard to the interests of, amongst others, individuals who are disabled or chronically sick, of pensionable age, of low income and those living in rural areas.

**3** Under the Electricity Act 1989 the Authority's functions are similar, to protect the interests of consumers, both existing and future, in relation to electricity conveyed by distribution systems, wherever appropriate by promoting effective competition.

## Initial Proposals – November 1999

**4** Ofgem proposed removing retail price controls and moving towards full deregulation for all domestic consumers. In doing so it would allow competition to regulate the behaviour of suppliers and to only intervene where anti-competitive behaviour was evident.

## Final proposals (2000)

**5** Ofgem considered that the risk of BGT abusing its market position once price controls had been lifted would be mitigated by the introduction of the Competition Act in March 2000.

**6** Consumer groups voiced concerns during the consultation process for the 2000 price controls. Ofgem noted these concerns and reassured them that it would have taken a more cautious view of the timings if the Competition Act did not come into force on 1 March 2000. Ofgem also said that it would use its new powers in the event of BGT abusing its dominant position.

**7** In its Final Proposals (Feb 2002) Ofgem stated that the financial penalties contained in the Competition Act would have a deterrent effect. There was, however, no discussion of the trade-offs faced by suppliers – including whether the financial penalties were sufficient to deter suppliers from acting anti-competitively.

## Ofgem's consideration of alternatives to removing price controls

**8** Ofgem removed price controls in stages, firstly removing controls on direct debit customers and then those on standard credit tariffs. It retained a relative price cap on Prepayment Meter tariffs from April 2001. During each consultation Ofgem presented options for both the retention and removal of controls, but the favoured option was always some form of removal.

## The appropriateness of the timing of the decision to remove price controls

**9** Ofgem's rationale for the timing of removing the retail price controls related to the introduction of the Competition Act, the additional powers and protections that this provided, and the development of competition in the supply market. Ofgem did not specify a threshold to be met that would indicate a sufficient level of competition in various sections of the market.

## Ofgem's timetable for removing price controls

**10** Competition for domestic customers was phased in between 1996 and 1999 and retail price controls removed between April 2000 and April 2002. Price controls for direct debit customers were removed in 2000 with the remaining price controls removed in 2002. Ofgem was, however, minded to remove the remaining price controls in 2001 and this formed part of their initial proposals. The removal of the price controls was delayed until the following year as a result of Ofgem's dissatisfaction with the progress made in particular areas, demonstrating some degree of flexibility with their approach.

## Ofgem's consultation and its influence on the decision-making process

**11** Much of Ofgem's consultation was through written documents, although workshops were convened for particular issues. Issues discussed during workshop sessions included measuring the development of competition and identifying the most appropriate criteria.

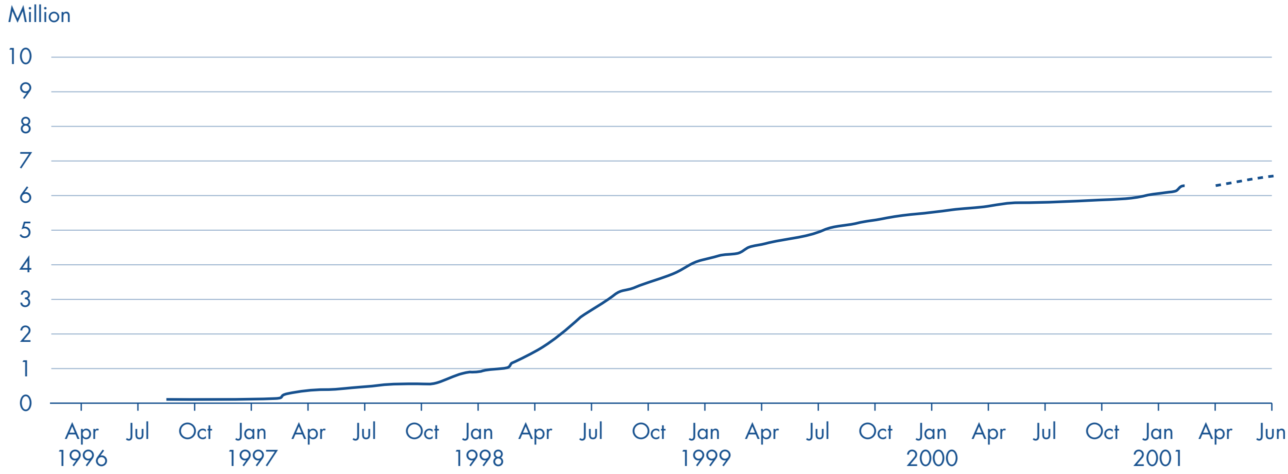
## The key evidence used by Ofgem to support its decision

**12** Ofgem used a variety of evidence sources to inform its pricing proposals, including an annual customer awareness survey of around 2,300 customers and the annual Competition Review. Ofgem placed significant weight on the levels of switching to demonstrate the heath of competition. Ofgem's analysis showed that 'net switching' away from BGT had reached some six million customers by April 2001, with around 14,000 gas customers a week for the year to September 2001 switching away from the previous monopoly supplier **(Figure 31)**. In electricity the net switching total for the period 1998 to 2001 was some 12 million customers, with 55,000 per week switching in the year to September 2001 **(Figure 32)**.

**13** Ofgem also considered the market share of BGT by customers and volumes supplied. Its analysis showed that BGT's share of gas customers supplied fell from 84 per cent in September 1998 to 67 per cent in September 2001 **(Figure 33)**. BGT's share of domestic gas supplied by volume was also in decline – 70 per cent in March 2001 compared with 72 per cent in March 2000.

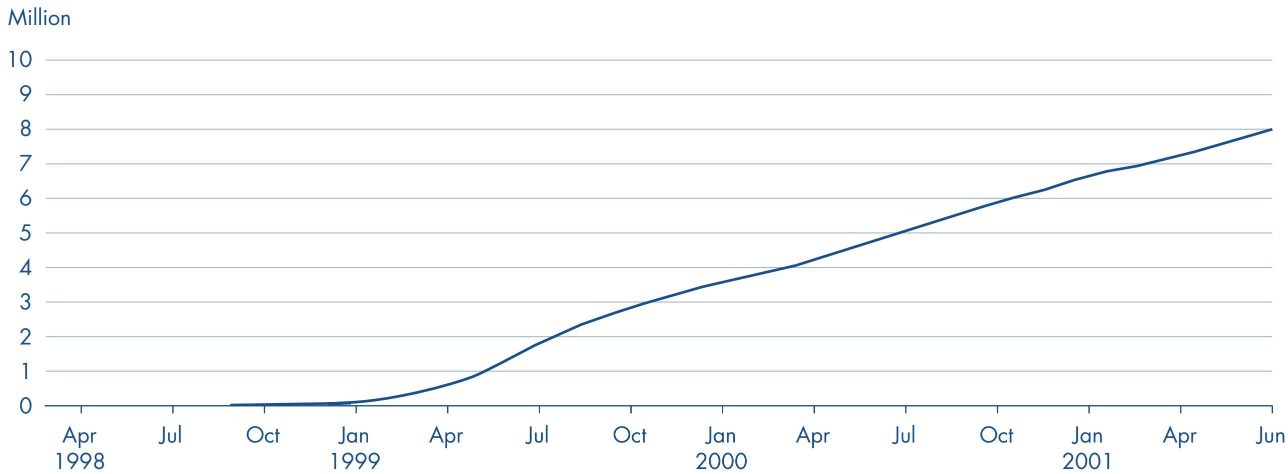
**14** Ofgem's analysis of market share (by customers supplied) of the ex-public electricity suppliers 'in area' demonstrated that, apart from some regional variations in less densely populated areas, the market shares of all the ex-public electricity suppliers were declining steadily **(Figure 34 on page 46)**.

**31** Net switching of gas customers 1996 to 2000




*Source: Ofgem, Review of domestic gas and electricity competition and supply price regulation, evidence and initial proposals, November 2001*

**32** Net switching of electricity customers 1998 to 2001




*Source: Ofgem, Review of domestic gas and electricity competition and supply price regulation, evidence and initial proposals, November 2001*

**33** BGT's market share of domestic gas supply by customers supplied

| | % |
|---|---|
| September 1998 | 84 |
| September 1999 | 75 |
| September 2000 | 71 |
| September 2001 | 67 |

*Source: Ofgem, Review of domestic gas and electricity competition and supply price regulation, evidence and initial proposals, November 2001*

**34** Market shares by customers supplied of the ex-PES suppliers 'in area'

| Group | Area | Market share at Sept 1999 (%) | Market share at Sept 2000 (%) | Market share at March 2001 (%) | Market share at Sept 2001 (%) |
|---|---|---|---|---|---|
| Innogy | Midlands | 89 | 78 | 74 | 68 |
| | Yorkshire | 91 | 80 | 75 | 69 |
| | Northern | 89 | 75 | 70 | 64 |
| TXU Energy | Eastern | 89 | 78 | 75 | 71 |
| | North West | 91 | 79 | 73 | 67 |
| SSE Energy | Southern | 91 | 80 | 76 | 71 |
| | North Scotland | 94 | 89 | 86 | 83 |
| | South Wales | 90 | 82 | 78 | 72 |
| London | London | 92 | 82 | 78 | 73 |
| | South West | 95 | 85 | 80 | 75 |
| Scottish Power | South Scotland | 93 | 82 | 76 | 72 |
| | Merseyside and North Wales | 90 | 79 | 74 | 68 |
| Powergen | East Midlands | 88 | 76 | 71 | 66 |
| Seeboard | South East | 89 | 81 | 76 | 70 |
| All areas | All areas | 90 | 80 | 75 | 70 |

*Source: Ofgem, Review of domestic gas and electricity competition and supply price regulation, evidence and initial proposals, November 2001*

**16** In the Final Proposals (February 2002) Ofgem considered that competition had developed sufficiently and that the rapid development in competition over the past 12 months substantially increased the regulatory risk that price caps would distort competition for customers. However, Ofgem's review of competition in 2001 provided evidence which did not consistently support Ofgem's view. For example, although switching rates were up by 14,000 per week over the previous year and licensed suppliers had increased in both markets, other factors considered as indicators of the level of competition were not so positive:

- consumers who considered that switching was too much hassle had increased 15 per cent in electricity and 10 per cent in gas;
- the number of **active** gas shippers and suppliers had both fallen by two when compared with the previous year;
- the number of **active** electricity suppliers had fallen by one and three, in England and Scotland respectively; and
- gas prices had increased in 2001-02 and the number of offers available to consumers had also fallen, reflecting, in Ofgem's opinion, the decrease in the number of competitors in the market.

**17** Ofgem's review highlighted that a number of barriers to entry still existed, including the issues surrounding debt blocking. These issues were a key consideration for Ofgem when deciding to remove the price controls. In the final proposals for the price regulation to commence on 1 April 2001 Ofgem stated that, in the period since publication of the initial proposals, it had held discussions with BGT and other suppliers to attempt to make 'substantial' progress to allow customers in debt to switch supplier. Ofgem considered that some progress had been made during this period, but it was not 'substantial'. Ofgem's decision to implement relative price controls from April 2001 was heavily influenced by this failure.

**18** The issue was raised again in the final proposals for the price regulation to commence on 1 April 2002, at which time Ofgem removed the remaining price controls. On 1 December 2001 suppliers commenced trials of a process aimed at allowing pre-payment meter customers to transfer suppliers following assignment of their debts. Ofgem considered that useful lessons were emerging from the trail but that further work was needed to find a solution to the problems of debt blocking.

APPENDIX FIVE

# Postcomm Case Study – Removal of Special Delivery (Next Day – for business account users) from the Royal Mail Price Control

## Introduction

**1** Postcomm removed Special Delivery (Next Day – for business account users) from the scope of the Royal Mail price control with effect from April 2006. Postcomm was minded during the early stages of consultation to remove Special Delivery (Next Day – for business account users) and Presstream from the price control, but reconsidered in light of consultation responses. The purpose of the overall price control regime is to:

- protect consumers from exploitation by Royal Mail as the incumbent operator with very substantial market power;
- promote efficiency on the part of Royal Mail through a mixture of incentives and penalties;
- allow competition to develop; and
- protect the universal service by ensuring that Royal Mail has the financial strength to support and maintain the service.

This section sets out how Postcomm came to the decision to exclude only Special Delivery (Next Day – for business account users).

**2** Postcomm usually undertakes a full review of the price controls every three to four years. It considers that this reflects a balance between the price control being long enough to provide market and regulatory certainty, whilst not being so long as to be vulnerable to market fluctuations. In undertaking its review of the Royal Mail products subject to price control it identified five criteria against which it measured the development of competition:

- Barriers to entry, including legal and economic barriers;
- Scale and nature of competition, including the number of companies entering the market, market volumes, market shares, range of price and service quality offerings and degree of innovation;
- Customer awareness and behaviour, including evidence of customers' awareness of competition and competitive options, and the extent of actual switching;
- Behaviour of Royal Mail, including reaction to competition, pricing behaviour and the degree of innovation; and
- Other factors, including the need for ex-ante price and service quality regulation to ensure the continued provision of the universal service.

**3** If Postcomm, after consideration of the factors outlined above, determines that a product should not be subject to price control it will still remain subject to any other applicable condition in Royal Mail's licence. Specifically, condition 7 or Royal Mail's licence requires Royal Mail to notify Postcomm and the market three months in advance of the launch of new products or changes to its current products. See **Figure 35 overleaf** for more details.

**4** Postcomm took a staged approach to setting out its aims, gathering views and making its final decision, as follows:

- Consultation
- Initial Proposals
- Responses to initial proposals
- Final proposals
- Responses to final proposals
- Final licence modifications and licence granted to Royal Mail (June 2006)

**35** Condition 7 of Royal Mail's licence

The requirement of condition 7 of Royal Mail's licence to give three months notice before new products or changes to existing products are implemented allows competitors to Royal Mail to inform Postcomm at an early stage of any concerns about potential anti-competitive effects arising from the new or amended products. It also provides transparency for Royal Mail's prices, and product terms and conditions.

Royal Mail can apply for an exemption for products or types of products from the notification obligations set out in Condition 7 (2) and (3) and therefore by implication the publication requirement set out in Condition 7 (4). Postcomm has the power to direct alternative or no notification requirements. When assessing an application, Postcomm considers its duties and policy objectives and the reasons that Royal Mail has set out in its application. Royal Mail applied for an exemption for Special Delivery on account, which includes Special Delivery (Next Day – for business account users) and Special Delivery 9am for business account users in October 2007. In the case of Special Delivery (Next Day – for business account users) Postcomm had in mind, among other things, whether effective competition existed in the sector of the market that the product serves and whether the sector of the market was sufficiently developed to protect the interests of users. Postcomm's current consultation about removing Special Delivery (Next Day for business account users) from the Condition 7 (2), (3) and (4) closed on 17 March 2008. Although removal from price control and exemption from Condition 7 are separate processes it is possible that in future the decision to remove products from a price control could occur in parallel with a decision to exempt a product from requirements of Condition 7.

*Source: Postcomm*

## Initial Consultation (March 2004)

**5** Postcomm undertook an initial consultation in March 2004 to explain the process and timetable which it intended to follow in carrying out its review. The key aims of this phase were: to make it easier for interested parties to identify how and when they could participate in the review and make their views known to Postcomm; to ensure that its decisions were based on sound evidence; and to take into account the views of stakeholders.

## Consultation on Principles (September 2004)

**6** The aims of the second consultation were: to seek views on the principles Postcomm should use for the price and service quality proposals to apply to Royal Mail's letters business; to outline initial thoughts on how to develop a robust price control package; and to propose objectives for the review. Postcomm received several responses to this consultation, with all supporting the proposal that price controls should only remain in operation where competition has not yet developed.

**7** In response to the consultation, Royal Mail criticised Postcomm's approach as being too subjective. It suggested that a more quantitative test be adopted, but it did not explain what test it was proposing or the information it believed was available that would reduce the level of subjectivity. Postcomm took the view that an assessment of the development of competition must take account of a range of evidence, and that it cannot be reduced to a simple quantitative test. One consequence of this is that it did not want to set pre-determined thresholds for factors such as market share, number of competitors and pricing behaviour, to determine the level of competition.

## Economic Consultancy – 'Scope of the Price Control' (November 2004)

**8** Postcomm commissioned a report from an economic consultancy to gain an understanding of which Royal Mail products should be within the price control and which could be removed. The consultancy assigned each product a score between 0 and 20 based on the following criteria: 1) barriers to entry; 2) scale and nature of competition; 3) customer awareness and behaviour; and 4) effectiveness of competition.

### Criteria Scores

0 = Good for competition

10 = Intermediate impact

20 = Bad for competition

The individual scores for each criterion were summed to give an overall score on the development of competition for a particular product.

### Overall Scores

70 to 80 = No competition

50 to 60 = Limited competition

30 to 40 = Borderline competition

0 to 20 = Developed competition

**9** For the two items that were considered for removal from the price control, Special Delivery (Next Day) and Presstream, the scores were both 40, indicating that borderline competition had developed. The analysis for each product is shown in **Figure 36**. The consultants made several recommendations to Postcomm, including:

- Presstream and Special Delivery (Next Day) could be retained in the control but regulated by their own separate sub-controls. Their exclusion, however, may be desirable if the number of sub-controls is limited.

**36** Analysis of Competition for Special Delivery (Standard) and Presstream

| Service | Criteria scores | Comment | Variation over time |
|---|---|---|---|
| Special Delivery (Next Day) | 1: 10 | Focus on services relating to guaranteed next day delivery. Barriers to entry are not very high, except the VAT privilege potentially (assuming a high proportion of customers are residential). | Developments in future depend on whether the customer mix is predominantly residential or predominantly business. If the former, competition is unlikely to develop and the score is unlikely to change but if customers are predominantly businesses competition may develop and a higher score may be appropriate in 2006 and 2011. |
| | 2: 10 | Other companies offer similar services to businesses but not to households or small businesses. We expect that a large proportion of the users of RM's product are residential customers and small businesses, however, suggesting that the main customer groups are not served by these alternative products. | |
| | 3: 10 | There is no evidence to suggest that households would switch but business customers would be expected to switch. The effectiveness of competition criterion is high given concerns about the need to protect the interests of non-business customers. | |
| | 4: 10 | The customer mix therefore leads to a conclusion that competition is reasonably effective for large businesses but ineffective for households (who are expected to be the main consumers of this product), resulting in borderline overall assessment. | |
| | **Total: 40** | **Borderline competition** | |
| Presstream | 1: 0 | Low barriers to entry. Large volumes allow entrants to take advantage of potential barriers to enter and a significant proportion of these customers are expected to be able to recover any VAT payments. | We expect, given the low barriers to entry and the expectation that residential consumers are willing to switch suppliers, that the degree of competition faced by Presstream will increase by 2006 and 2011 (score on scale and nature of competition reduced to 10 and then 0). This is particularly likely if new entrants can use access agreements to deliver periodicals by post. As more alternatives become available publishers, who are highly price sensitive are increasingly likely to switch, particularly if have guarantee that all subscribers will be reached via access arrangements (score reduced to 0 by 2011). Uncertainty about the extent and scale of competition that will arise over time, and the potential that not all customers will benefit (e.g. those that read specialist magazines), means that a score of 10 is retained for the final criterion. In total, the score reductions will move the category assessment to 4 by 2011 (score 10). |
| | 2: 10 | There are no major alternative operators providing a similar service at present. However, other operators, for example Hays, have provided similar services to publishers in the past and provided a viable alternative to RM. | |
| | 3: 10 | Little evidence of customer switching but publishers are expected to be highly aware of product prices and as large buyers are expected to be aware of alternative offerings when they arise. | |
| | 4: 20 | Given the current absence of alternative suppliers, competition is not considered to be highly effective at present and this criterion is used as a brake on the overall assessment. | |
| | **Total: 40** | **Borderline competition** | |

*Source: Scope of the Price Control, a Final Report Prepared for Postcomm, Frontier Economics, October 2004*

## Initial Proposals (June 2005)

**10** Postcomm's initial proposals included the removal of Special Delivery (Next Day – for business account users) for large business users and Presstream products from the price control, as suggested in the Scope of the Price Control report. Postcomm received a significant response from periodical and publishing customers regarding the proposal to remove Presstream from the control. The main concern raised was that prices for Presstream products would rise significantly and that competition to Royal Mail was not well developed. The majority of respondents agreed that Special Delivery (Next Day – for business account users) should be excluded from the price control.

## Final Proposals (December 2005)

**11** Postcomm's proposal to remove Presstream from the price control raised considerable concern from periodical and publishing customers regarding potential substantial price increases. Mailers of magazines and other publishers argued that they had no real alternative to Royal Mail, especially for smaller circulation titles and those requiring an overnight delivery. The Periodical Publishers Association believed that Presstream 1 and 2 should be price controlled because of the importance of the postal route to market and that newsagents, for example, do not provide a sufficient competitive restraint on Royal Mail's pricing. Postcomm concluded that Presstream 1 should be retained in the control, whilst Presstream 2 should be removed.

**12** The majority continued to oppose the removal of Presstream 2 from the price control, with Royal Mail the only respondent in favour. The majority of respondents were also pleased with Postcomm's decision to retain Presstream 1 in the control.

## Proposed Licence Modification (March 2006)

**13** At the Commission meeting in February 2006 the Commissioners were asked to review Postcomm's earlier decision to exclude Presstream 2 from the price control. The main arguments put forward for keeping it within the price control were that the prospect of competition was looking more remote, due to one of the key competitors, Express Dairies, exiting the market, and the lack of interest from operators using downstream access in seeking an access product for Presstream from Royal Mail.

# APPENDIX SIX

# Market data

1 This section sets out key market data in the three sectors under review.

## The Communications Sector

2 The retail price control on fixed line telecoms lapsed in August 2006. Market data from the post-removal period is therefore quite limited. We therefore concentrated on pre-existing trends supplemented by additional data where this is available.

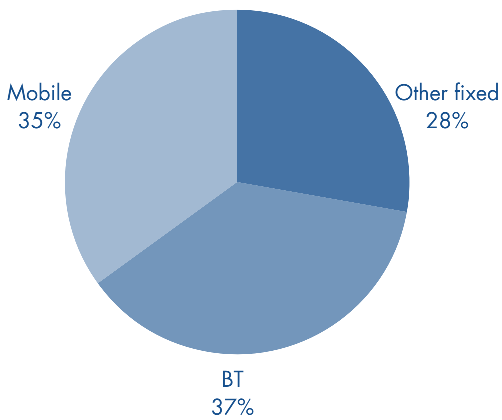
### The telecommunications market as a whole

3 BT remains by far the largest player in the wider telecoms market, with a market share substantially greater than all other fixed line operators combined. Even with the inclusion of the mobile operators **(Figure 37)** BT alone has revenues higher than either of the other market segments.

4 There is, however, a continuing decline in BT's market share over the period from 2002 to 2006 with market share largely being lost to increased indirect access **(Figure 38 overleaf)**.

5 The recent costs of fixed line voice calls are illustrated in **Figure 39 overleaf**. This shows that there is a trend towards lower real costs for the fixed line component of the residential bundle of services (considered in isolation from other elements of a bundle, such as broadband).

**37** Market share of telecoms in 2006

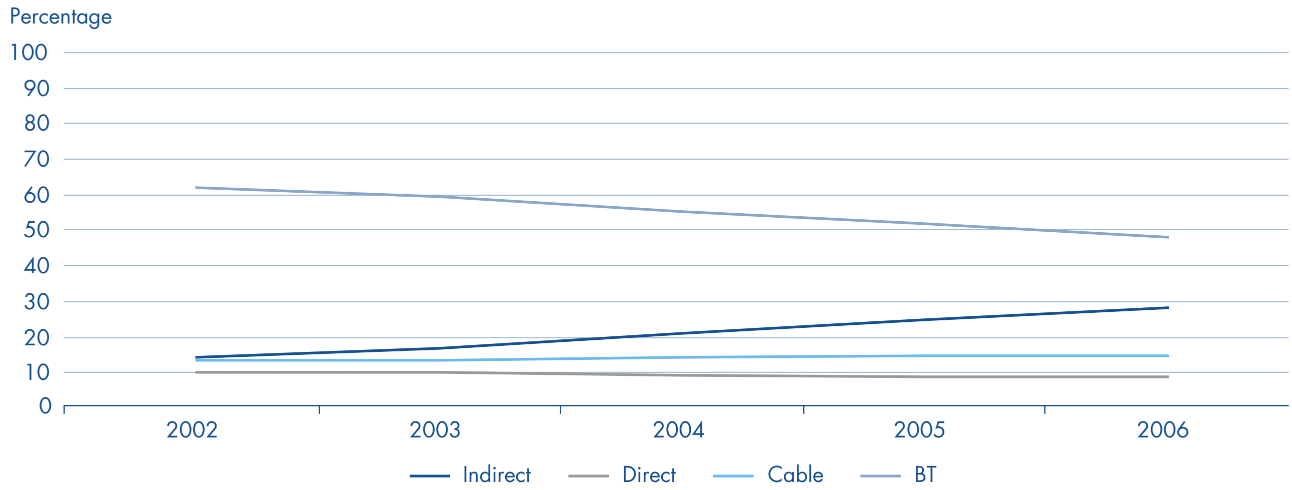



*Source: Ofcom, The UK communications market 2007*

### The development of market entry

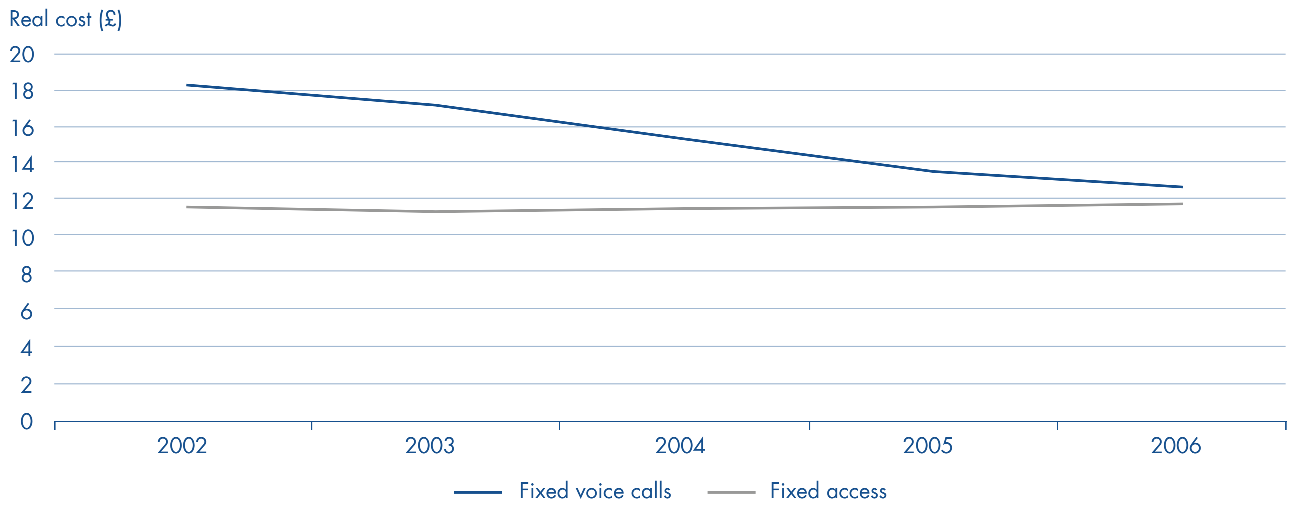
6 The central plank of Ofcom's approach to regulation of the fixed line market is the functional separation of BT (leading to Openreach) and the continuation of price controls in key segments of the wholesale market. Openreach represents a functional separation of BT so that the wholesale products such as equivalent Local Loop Unbundling (LLU), Wholesale Line Rental (WLR), Backhaul Extension Services and Wholesale Extension Services products are sold to BT at arm's length prices.

**38** Market share of fixed call volumes




*Source: Ofcom, The UK communications market 2007*

**39** Real cost of residential bundle of telecom services (fixed element only shown)

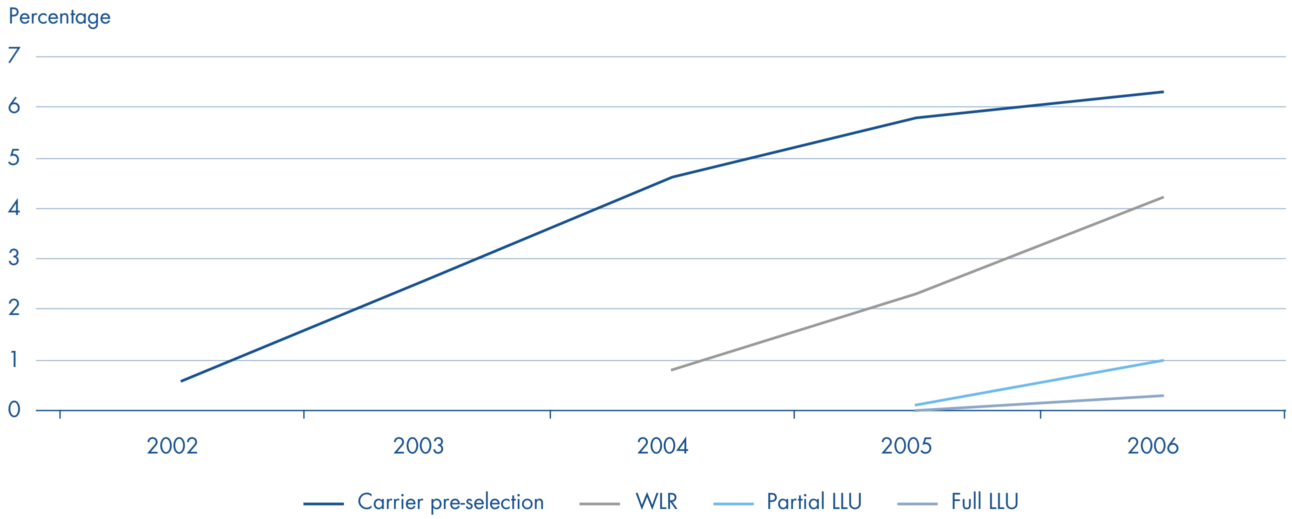



*Source: Ofcom, The UK communications market 2007*

**7** Wholesale pricing by Openreach remains regulated by Ofcom. Ofcom considers that to the extent that this achieves equivalence of inputs and levels the playing field for market entrants, this should promote competitiveness at the retail level. **Figure 40** demonstrates how access to each of the wholesale products by competitors to BT has developed since 2002.

**8** Research conducted on behalf of Ofcom revealed that, as at Q4 2006, some 36 per cent of residential fixed line customers had switched supplier at least once. This represented a significant increase from a similar survey conducted a year earlier, in which 28 per cent of the residential fixed line customers surveyed indicated that they had switched at least once. **Figure 41** illustrates the relative ease of switching between fixed line providers.

**40** Alternative access




*Source: Ofcom, The UK communications market 2007*

**41** Ease of switching fixed line supplier

| | Don't know | Very difficult | Difficult | Fairly easy | Very easy |
|---|---|---|---|---|---|
| Q4 2005 | 16 | 5 | 6 | 36 | 37 |
| Q4 2006 | 13 | 3 | 7 | 42 | 34 |

*Source: Ofcom, The UK communications market 2007*

NOTE

Rounding of one per cent in Q4 2006 data.

# The Energy Sector

## Market Shares

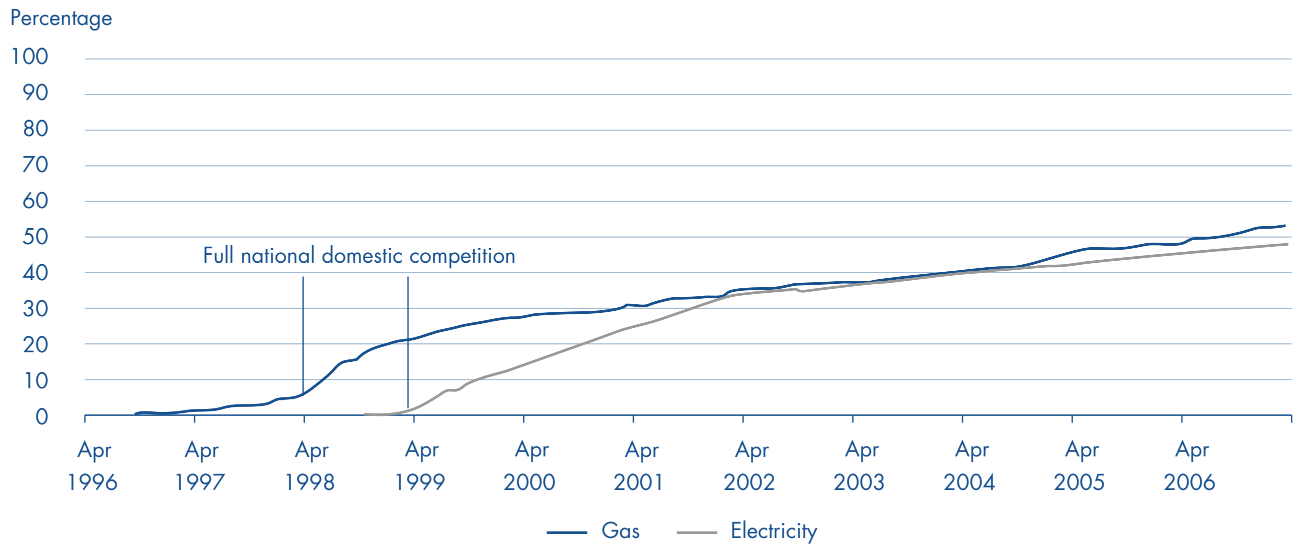
**9** The market share of new entrants in the gas and electricity markets has been rising steadily since the introduction of competition **(Figure 42)**.

**10** Although the markets are becoming more competitive the incumbents still have large market shares (having a market share above 40 per cent) five years after the removal of price controls. In the gas market the former incumbent has continued to lose customers to the other major energy companies. Over the last five years the national electricity market shares of the energy companies have remained broadly constant as the regional incumbents have lost customers in their old monopoly areas and gained them elsewhere.

**11** **Figure 43** below shows a gradually increasing market share for entrants in the gas sector.

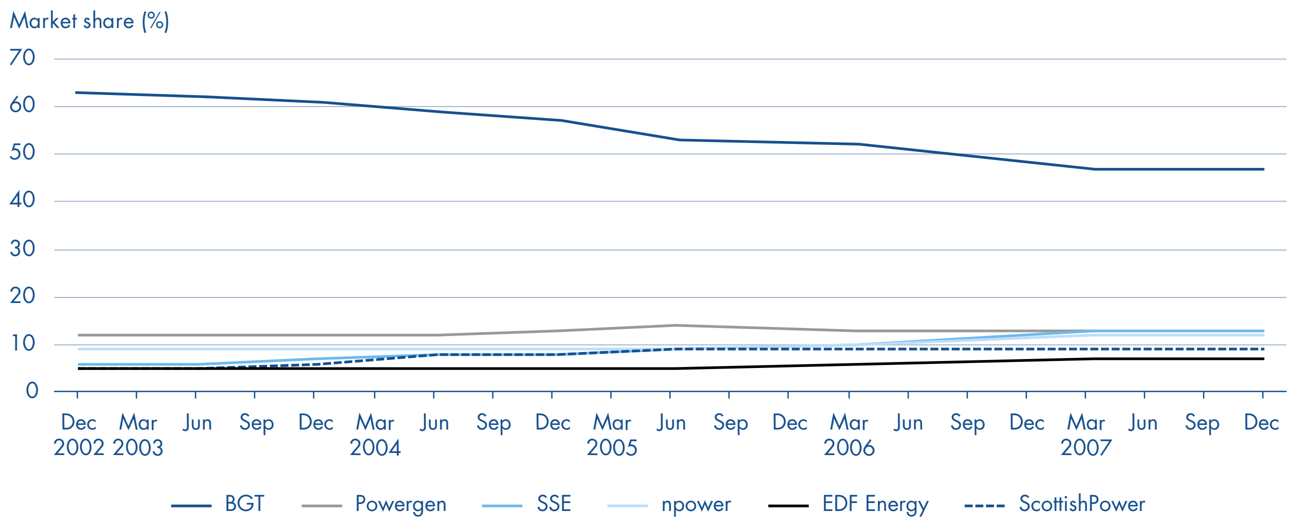
**12** **Figure 44** shows a fairly static picture of market share development in the electricity market.

**42** Market share of new entrants



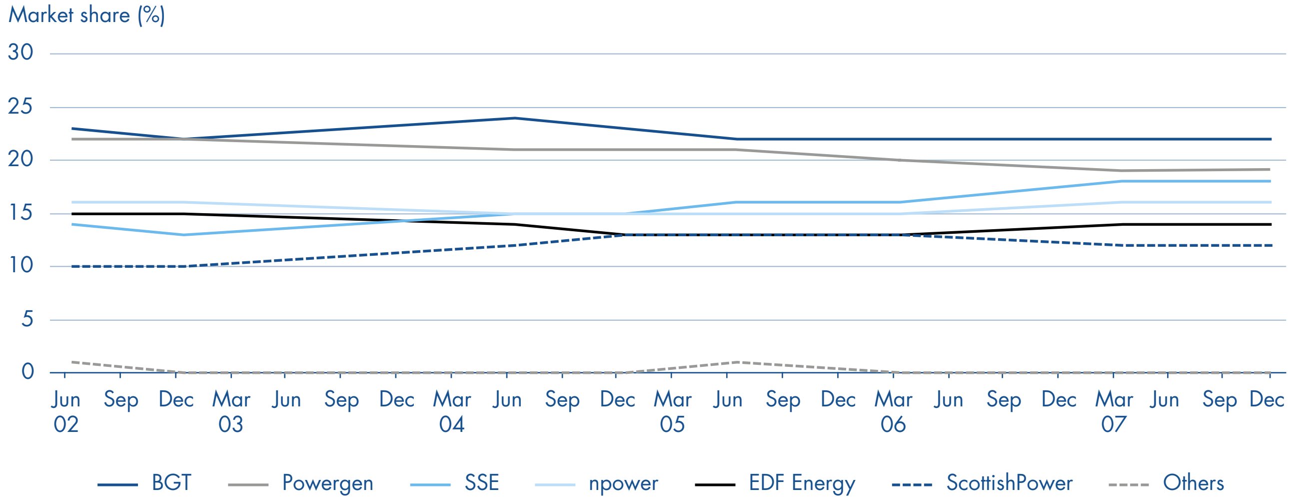

*Source: Ofgem, Domestic market retail report, June 2007*

**43** Market shares in the gas sector 2002-2007 (quarterly)




*Source: Ofgem, Domestic market retail report, June 2007*

**44** National market share in electricity 2002–2007 (quarterly)




*Source: Ofgem, Domestic market retail report June 2007*

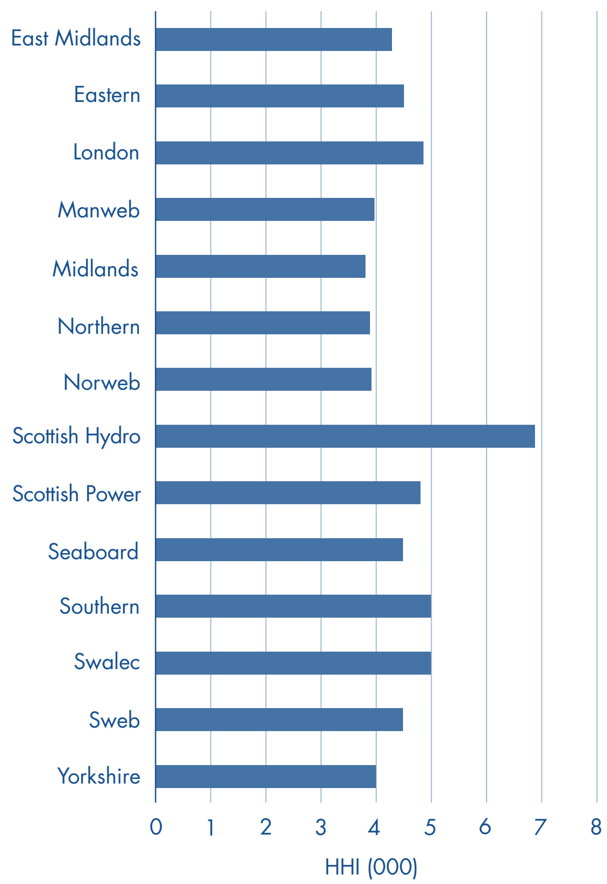
**13** The regional market share data can also be turned into Herfindahl-Hirschman Indices (HHI) to show concentration **(Figure 45)**. The high HHI levels in regional domestic electricity markets show that they are highly concentrated – a monopoly market gives a score of 10,000, and a market is regarded as "highly concentrated" if the HHI exceeds 1,850.

## Switching Suppliers

**14** Ofgem's analysis suggests that consumers do react to price differences by switching. If firms increase prices in the electricity sector they will lose more market share and this is what would be expected in a competitive market. **Figure 46 overleaf** shows that even if the incumbent sets prices below the average price it still loses market share because the number of consumers it will lose to lower priced firms will be greater than the number regained from higher priced firms.

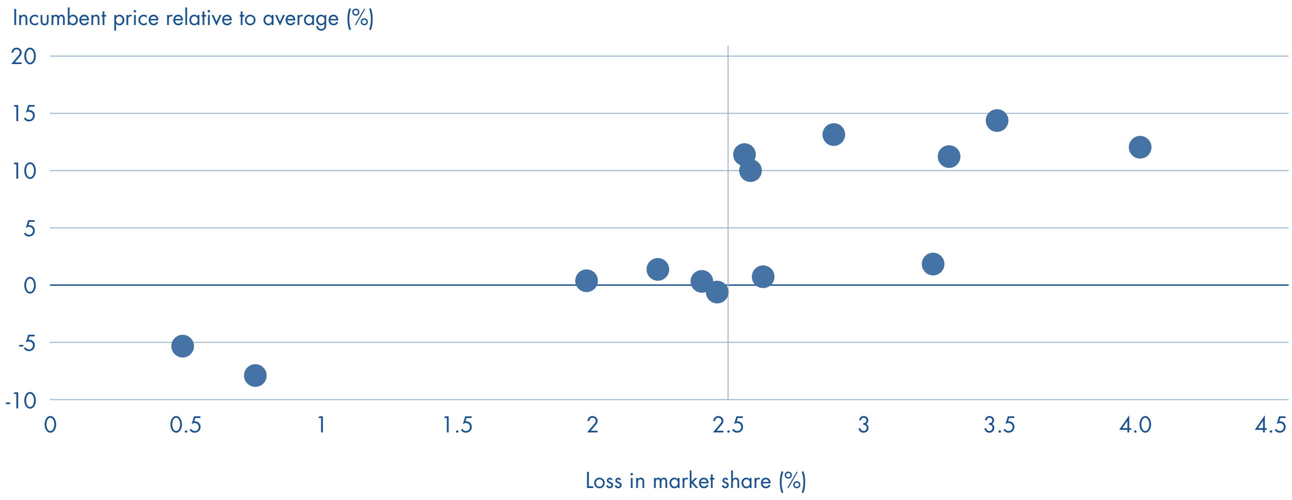
**15** For both gas and electricity Ofgem analyses the transfers involving the incumbent and new entrants (Figure 44). The increase in the transfers between new entrants indicates that competition is becoming more broad-based and that the original energy duopoly between the two former local incumbents is being reduced. This is shown in **Figure 47 overleaf**.

**45** Regional domestic electricity HHI's – April 2005



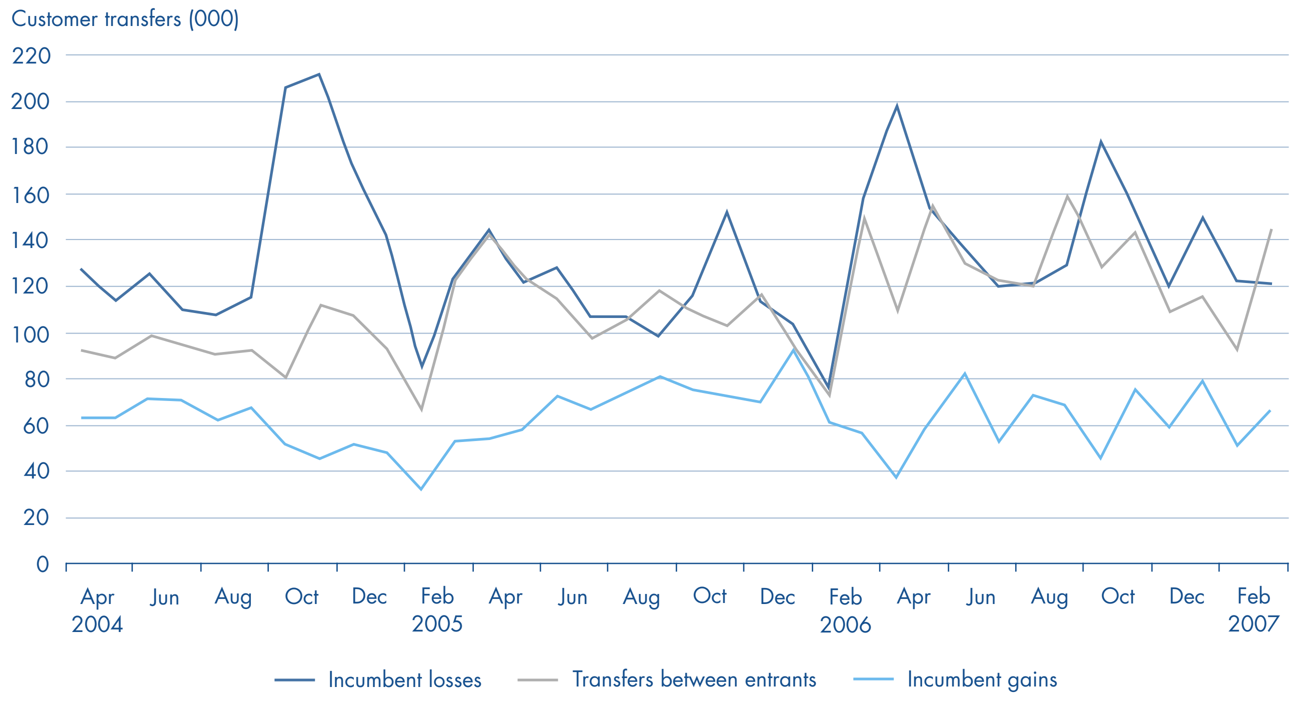

*Source: Energywatch*

**46** Electricity Incumbent price, relative to average price, against loss of market share (12 months to March 2007)




*Source: Ofgem, Domestic retail market report, June 2007*

**47** Transfers in gas




*Source: Ofgem, Domestic retail market report, June 2007*

## Pricing transparency

**17** Consumers often give price as the most important factor when deciding whether to switch, so therefore it is important that pricing is transparent and easy to understand. **Figure 48** shows the ease of comparison of electricity supplier charges and suggests that there is still some confusion about how to compare charges between operators.

## Price development

**18** Gas and electricity retail prices have followed a similar pattern. Increasing prices do not necessarily mean poor performance because of the large influence of external (input) costs. The movement in gas and electricity prices for the household sector is shown in **Figure 49 overleaf.**

## The Postal Sector

**19** Special Delivery (Next Day – for business account users) for bulk mailers, the product for which the retail price control was removed, is considered by Postcomm to be part of the guaranteed next day express market.

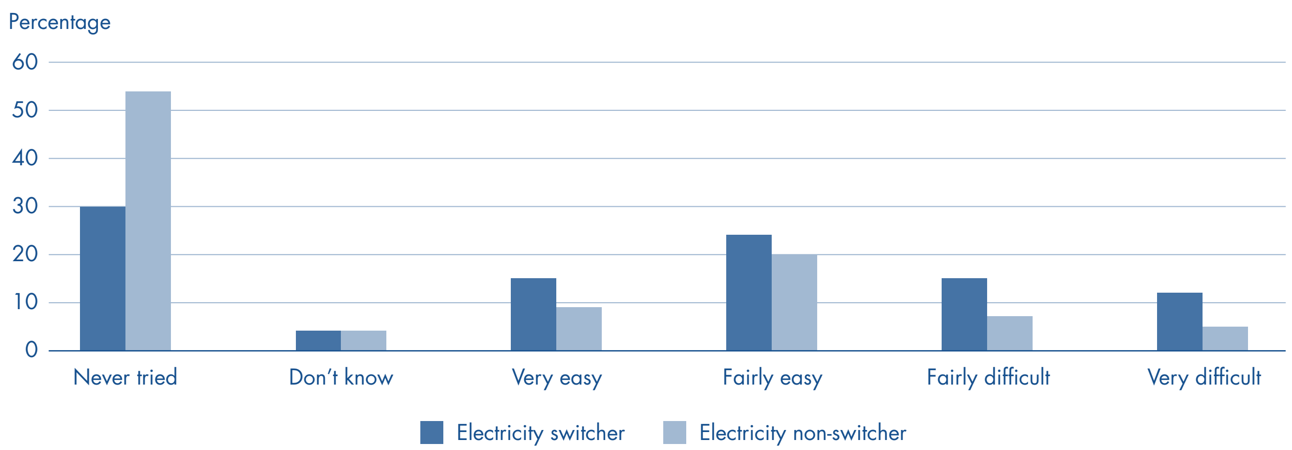
**20** The guaranteed next day express market is concerned with the collection and delivery of time-specific items. The overall annual value of this market within the UK has been estimated by Royal Mail to be worth £3.53 billion[34]. Royal Mail's total revenue for the Special Delivery (Next Day) service was £350 million in 2006-07. This equates to approximately 10 per cent of the total market. Special Delivery (Next Day – for business account users) revenues for the same period were £125 million or approximately 4 per cent of the total guaranteed next day express market. In addition, Royal Mail's operating division Parcelforce offers services in this area and this brings Royal Mail's overall share of the market to 14 per cent.

**21** The relevant sectors of the guaranteed next day express market and an estimation of Royal Mail's share of these sectors has been summarised in **Figure 50 overleaf**.

**22** There are a number of ways that the guaranteed next day express market can be segmented. Of particular relevance to Special Delivery (Next Day – for business account users) are the timed delivery and the business to consumer sectors. As can be seen in **Figure 51 on page 59** a number of express operators in the guaranteed next day express market offer timed deliveries.

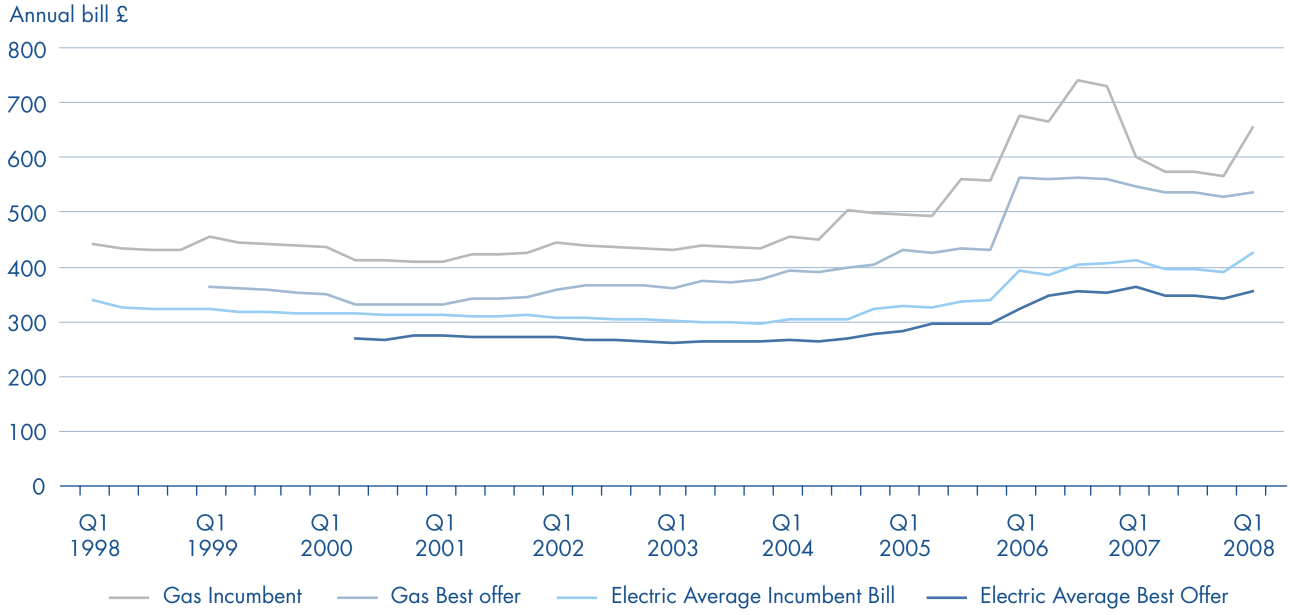
**23** Postcomm believes it is more appropriate to compare Royal Mail's Special Delivery (Next Day) service with the 12pm services of its competitors, as it is much closer in time to this rather than services that guarantee delivery by the close of business. Within this market Royal Mail has approximately a 50 per cent share of the sector for its Special Delivery product overall and 18 per cent for Special Delivery on account (see Figure 50).

**48** Ease of comparison of electricity supplier charges




*Source: Ofgem*

## 49 Domestic gas and electricity bills in real terms 1998–2008




*Source: Ofgem*

NOTE

Figures for Q1 2008 are based on all published price charges as at 8 January 2008.

## 50 Market sectors and Royal Mail sector share

| Market | Special Delivery on account % | Total Special Delivery % | Parcelforce % | Royal Mail Total % |
|---|---|---|---|---|
| Total guaranteed next day express market | 4 | 10 | 4[1] | 14 |
| Timed guaranteed next day express sector | 18 | 50 | 2[2] | 52 |
| Business to consumer guaranteed next day express sector | 10 | 27 | 9 | 36 |

*Source: Postcomm*

NOTES

1 As supplied by Royal Mail – only includes Parcelforce sold on account.

2 As supplied by Royal Mail – only includes Parcelforce sold on account.

**51** Guaranteed next day express market timed delivery options

| Company | 7.30am | 9am | 10-10.30am | 12pm | 1pm | Close of business | Evening |
|---|---|---|---|---|---|---|---|
| Royal Mail Special Delivery | | ✓ | | | ✓ | | |
| TNT | | ✓ | ✓ | ✓ | | ✓ | |
| Initial City Link | ✓ | ✓ | ✓ | ✓ | | ✓ | |
| DHL | | ✓ | ✓ | ✓ | | ✓ | |
| Amtrak | | ✓ | ✓ | ✓ | | ✓ | ✓ |
| FedEx (ANC) | | ✓ | ✓ | ✓ | | ✓ | |
| Business Post | | ✓ | ✓ | ✓ | | ✓ | |
| Parcelforce | | ✓ | ✓ | ✓ | | ✓ | |
| UPS | | ✓ | ✓ | ✓ | | ✓ | |

*Source: Postcomm*

# APPENDIX SEVEN

# Consumer switching journey

**Customer not considering switching**

51 per cent of energy and 53 per cent of fixed telephony customers would not switch if it was free and simple to do so. 47 per cent of postal consumers currently using Royal Mail would never switch.

Consumers may never have switched supplier or may have switched before but are not likely to do so again.

Consumers may not be considering switching for a variety of reasons, for example because they:

- **do not know it is possible** – 5 per cent of gas customers are not aware they can change supplier;
- **cannot switch**, for example under the terms of their contract;
- **don't know anything about alternative suppliers** – 47 per cent of fixed telephony customers could name only one or no suppliers;
- **are satisfied with their current supplier** – 41 per cent said they did not switch because they were happy with Royal Mail's service;
- **don't think there is any difference** between providers;
- **do not consider the product to be a high enough priority** – 55 per cent of customers agree that life is too short to worry about saving a few pounds here and there;
- have a **negative perception** of switching.

**Consumer is considering switching but not acting**

46 per cent of postal consumers would consider switching some or all mail from Royal Mail.

Around 51 per cent of fixed telephony consumers show some interest in the market.

A customer may be prompted to consider switching by a number of factors such as rising prices; poor quality of service from their current supplier; new requirements; advertising by alternative suppliers; advice from consumer groups or the media; family and friends; or the end of a contract.

A customer may not be acting because they:

- **don't know enough** about alternative suppliers or the switching process;
- are **unable to leave** their current contract or don't want to leave it;
- are **used to their current supplier** and/or are not sure they can trust other providers – 70 per cent would rather use a familiar trusted company than a new one offering a better deal;
- think switching **requires too much time and effort** – 22 per cent of fixed telephony and 18 per cent of energy consumers gave reasons related to lack of time or too much hassle for not switching;
- **don't believe the economic benefits outweigh the costs involved** – 17 per cent of energy consumers and 21 per cent of fixed telephony consumers do not expect to make savings from switching supplier.

*Source: Ofcom, The Consumer Experience; Ofgem, Consumer experience survey 2005 and Domestic Market Retail Review 2007; Postcomm, Business Customer Survey 2007; and National Consumer Council, Switched onto Switching, 2005*

**Consumer is researching and planning to switch**

This could be the first time a consumer has planned to switch or they may regularly research the best deals with the intention of switching if they find one – Ofcom rates 21 per cent of consumers as 'engaged' in the market and Energywatch found 26 per cent of energy consumers to be 'serial switchers'.

Consumers use a variety of sources of information e.g:

- **suppliers** – 36 per cent of gas customers use company representatives as a source of price information;
- **switching websites**;
- **personal contacts** e.g. family and friends – 24 per cent had acted as an advisor to others on fixed telephony, rising to 40 per cent of 16–24 year olds; or
- **other sources** e.g. consumer groups or the media.

Customers may face challenges when researching and planning to switch:

- **lack of knowledge on their current usage** – in fixed telephony 30 per cent overestimated and 36 per cent underestimated their monthly outlay;
- **unable to find, access, understand or trust information on alternative deals** – 16 per cent of fixed telephony customers and 15 per cent of energy customers thought it was 'not easy' to find out what companies offer;
- **lack of time or desire** – ¼ of energy switchers did not try to compare prices before switching, 58 per cent of electricity customers, 62 per cent of gas customers and 51 per cent of fixed telephony customers spend only a few minutes looking around before switching; or
- **unable to assess which deal best meets their requirements** – 30 per cent of fixed telephony customers found it difficult to make price comparisons between providers and 39 per cent found it difficult to make quality of service comparisons.

Consumer Switches

# ENDNOTES

1 The price control has been removed for account users (i.e. medium and large businesses) only, not for the residential sector.

2 See Appendix 2 paragraph 4 for more details of each regulator's duties.

3 Each regulator has classified those consumers who are vulnerable customers according to their particular sector.

4 Source: ONS data set DK9U, Electricity, gas and miscellaneous energy. See Appendix 2.

5 Ofgem press release *'Ofgem launches probe into energy supply markets'*, 21 February 2008. The initial results of the probe are expected to be published before the end of September.

6 *Switched on to Switching*, National Consumer Council, 2005.

7 For all business products, not just delivery products.

8 *Business Customer Survey, 2007*. Postcomm.

9 Taken from a working paper *Do consumers switch to the best supplier?* by Wilson and Waddams-Price. This work did not examine the impact of dual fuel offers on the price of the new deal. More research is therefore needed in this area.

10 Behavioural economics demonstrates that decision making is not always rational. First impressions and personal experience also play strong roles in shaping judgments, even when more accurate information is available. Regulators must therefore have an understanding of such issues if they are to regulate effectively.

11 House of Lords – Select Committee on Regulators, *UK Economic Regulators: 1st report of session 2006-07* (HL paper 189), November 2007.

12 The water industry in Scotland remains in public ownership.

13 Presstream is a specialist distribution service provided by Royal Mail for frequent publishers of magazines, journals and newsletters.

14 Special Delivery guarantees delivery, offers on-line tracking and provides compensation for lost items.

15 Special Delivery was regulated for Royal Mail but exempt from the need for a licence and therefore unregulated for other operators.

16 For providers who have at least £4 million in net revenues per quarter and 100 million minutes of calls handled to End-Users per quarter – these indicators are service provision; reported faults; service restoration; complaints; and billing accuracy.

17 *Business Customer Survey 2007*, Postcomm.

18 *The Consumer Experience 2007*, Ofcom.

19 *Do consumers switch to the best supplier?* Wilson and Waddams-Price, CCP working paper 07-6. This is a working paper which did not examine the impact of dual fuel offers on the price of the new deal. Further research in this area is needed.

20 *Compare and contrast: how the UK comparison website market is serving financial customers, 2007*.
The Resolution Foundation is an independent research and policy group. Its report recommended a voluntary code of practice for price comparison sites operating in the financial services market.

21 *Switched on to Switching*, National Consumer Council, 2005.

22 *Business Customer Survey 2007*, Postcomm.

23 For example, how they use information and make decisions, attitudes towards choice and the effects of ethnicity, age and location. *The consumer agenda on regulation* by Ed Mayo and Philip Cullum (2007) sets out some of the complexities into which regulators need to develop real insight.

24 *The Consumer Experience 2007*, Ofcom.

25 *Switched onto switching*, National Consumer Council, 2005.

26 National Consumer Council.

27 Participation takes into account switching suppliers, negotiating with current suppliers, staying informed and awareness of changes in the market and likelihood to switch or change current product or service in the future.

28 For example, in 2005, Energywatch published research which segmented energy consumers into 26 per cent serial switchers (switched supplier twice or more in last 5 years), 35 per cent reactive switchers (switched once, typically as a result of marketing from suppliers) and 39 per cent non-switchers (never changed supplier), Energywatch, *Responding to Consumer Needs*, June 2005.

29 Actions have included the production and circulation of a Consumer Insight bulletin to all staff in the organisation and the building in of consumer research to a number of work streams including new arrangements for complaint handling and a review of debt and disconnection processes.

30 *The Consumer Experience 2007*, Ofcom.

31 *Pre-payment meters and fuel poverty, 2007*, Ofgem.

32 *Business Consumer Survey 2007*, Postcomm.

33 Presstream is a Royal Mail product for frequent publishers of magazines and journals.

34 National Audit Office, *Pipes and wires* (HC 723), April 2002.

35 Royal Mail Application for a Direction from Postcomm for exemption from Condition 7 for Special Delivery sold on account. October 2007.

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Protecting consumers? Removing retail price controls

A report by the Comptroller and Auditor General


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