



National Audit Office

Protecting consumers? Removing retail price controls



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 Telecoms regulator (Ofcom) originally established in 1984. Ofcom established in 2002. | Ofgem Gas regulator (Ofgas) originally established in 1986, electricity regulator (Offer) originally established in 1989. Ofgem established in 2000. | Postcomm 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) 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 vulnerable³, 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 cent⁴, 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 consumers⁷ 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 cost⁸, 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' economics¹⁰ 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.