

The Worshipful Company of Fuellers

10th Annual Energy Lecture

Presented by David Gray

Chairman, Gas & Electricity Markets Authority

11th September, 2014

I'm very pleased to have been invited to present the 10th Annual Energy Lecture. I have to confess that I haven't previously had much contact with the Fuellers but when I was asked to speak tonight I did some research. I knew the Fuellers, in its current form, was a relatively new body in the context of City livery companies but I hadn't realised that its roots date back to the 14th century and to the Livery Company of Woodmongers and Coal Sellers. I saw that this company surrendered its charter in 1667, the year after the Great Fire of London, and I wondered whether this might be an early example of the unpopularity of the energy industry, a subject to which I will come back in a moment.

As many of you will know, I was an executive director of Ofgem and member of the Authority from 2003 to 2007, running the Networks division, and it has been fascinating to come back to Ofgem and to the wider energy debate after 6 years of focussing largely on other things.

It has, of course, been a particularly busy and interesting year since I took up my position as Chairman last October. The main feature has been the intense scrutiny of energy markets, the energy companies and Ofgem itself. The combination of the party conference season last year followed by a round of price rises in October lit a fuse which led to an explosion of dissatisfaction with the energy market and an intense public debate.

In many ways this debate has been healthy. It's best that the issues are out in the open and are being discussed. But it also has disadvantages. One of the main features of the energy sector recently has been consumers' lack of trust in the energy companies. This is understandable but the heated debate linked to consumer mistrust risks becoming self-feeding. Consumers don't trust the energy companies; so the commentary from media and politicians is hostile; which makes consumers trust the companies even less.

Not surprisingly, in this environment, Ofgem itself has come in for quite a lot of criticism.

Many have accused us of doing nothing – or doing too little too late – in the face of rising prices and unacceptable behaviour by some energy suppliers. To a significant extent the criticism is simply that we failed to prevent price rises – something which we have no powers and only limited influence to achieve.

But behind this there has been a more interesting debate about our interventions to simplify the market for consumers. Many would like us to have gone further: taking more aggressive actions against the energy companies and perhaps restricting the permissible range of tariffs even further.

In contrast, an eminent group of former regulators has argued that Ofgem's interventions are themselves responsible for much of the increase in prices and industry profits. In essence, their argument is that the market was working well before 2008 but then Ofgem started interfering and prices and margins have since risen as a result.

I'd like to spend a few minutes considering both these charges and argue that real life is perhaps rather more complicated than either line of argument suggests and that, even if you believe that some of the problems today can be traced back to Ofgem's actions, that's not the whole story.

But first let me set the scene. The two big features of the last 10 years have been rising prices combined with persistent poor customer service and mis-selling by the Big 6 energy suppliers.

Prices have risen substantially, driven primarily by increases in the price of gas on the international wholesale markets and, to a lesser extent, by government measures in support of decarbonisation and fuel poverty objectives, which are paid for by energy consumers. Rising network costs have also had some impact.

To put some numbers on this, in a form that illustrates the impact on domestic energy consumers, the average percentage of total household expenditure represented by energy¹ was, in the 20 years before privatisation, reasonably steady at around 6%. That figure fell to less than 3% in 2004 but has since risen to about 4.6%, reversing rather more than half of the gains since privatisation.

To be clear, there was nothing Ofgem could do about rising wholesale gas prices but this seems to me to be the essential back-drop to events since about 2004, and is in marked contrast to the period from privatisation until 2004 when prices were falling, consumers were reasonably happy and politicians and the press felt no need to get involved.

There has also been a history of failure by the companies to meet increasing consumer expectations. People did not expect much from the nationalised energy industries but opening up the domestic market to competition pushed the new energy companies into the consumer-facing world, in which expectations have been rising steadily, in line with positive experience in many other sectors.

Unfortunately, the energy companies have not kept pace. It's not that customer service hasn't improved. It has improved but it hasn't improved fast enough and there have been some serious failures; most notably around the introduction of new IT systems and mis-selling by the Big 6. Much of the switching in the early stages of retail competition was driven by doorstep selling but this was beset by malpractices such that many consumers who switched were actually moving onto worse deals.

It probably isn't useful to speculate on how much of the recent furore around the energy sector is due to rising prices and how much to poor customer service but the fact is that customer tolerance of rising prices certainly hasn't been helped by the perception of shortcomings in service.

¹ Average share of gas and electricity in weekly household spending (including housing costs)

Now I'd like to turn to the claim that Ofgem has been sitting on its hands. That simply isn't true. In fact, the Authority has had an extremely busy agenda. Look at some of the big decisions we have taken over the last 12 months:

- In network regulation we have been concluding the final round of our new RIIO approach to price controls with the review of charges for the electricity distribution companies. Last December we "fast-tracked" the 4 distribution companies owned by WPD and in July we published our draft determinations for the other 10 companies. This is the latest stage in a process which seen reductions in real terms of more than 40% in operating costs of the electricity distribution companies since privatisation. If you assume that these costs would otherwise have moved in line with inflation, that's a saving of £1.75 billion a year for today's consumers.
- In electricity transmission we have made important decisions on transmission charging, to ensure that generators pay the right charges for use of national transmission network;
- We have also introduced a new regulatory regime for interconnectors, to facilitate improved links between Great Britain and continental Europe, and are working to bring together the currently separate regimes for onshore transmission, offshore transmission and interconnectors. This may lead to greater use of competitive tendering for major projects, which is already established in the offshore regime.
- In the supply business we have introduced our retail market reforms, aimed at making the markets simpler, clearer and fairer for energy consumers.
- One important aspect of this is the introduction of standards of conduct for energy suppliers to set out what consumers should expect from their supplier and to provide a framework within which we can take action against poor performance
- That is not to say that we haven't taken action against poor performance by the companies. We have. Over the last year we have imposed penalty packages totalling £36 million, of which about £1 million was fines while the vast majority comprised customer redress payments.
- We have also completed a review of our enforcement activities, setting up a new separate and expert decision making panel and indicating our intention to implement a substantial step up in the scale of penalties.
- We have published a new consumer vulnerability strategy under which we pursue a wide range of actions to help vulnerable consumers, such as monitoring debt and disconnection rates, improving the way suppliers and network companies target support to vulnerable consumers, as well as working in partnership with organisations like Citizens Advice
- To ensure security of supply over the next few years we have worked with National Grid to introduce a new series of measures it can use to procure additional electricity generation and to make arrangements to reduce demand in periods of system stress.
- Perhaps most importantly of all we undertook, jointly with the OFT and the CMA, an assessment of the state of competition in the energy markets, following which the Authority made the decision to refer the energy markets to the CMA by way of a Market Investigation Reference.
- In the background to all this we appointed a new chief executive, Dermot Nolan, a competition and regulatory economist who comes to us with an impressive track record as Chair of the Irish energy regulator, the CER.

So, we certainly haven't been sitting on our hands and, although much of our work is technical and tends not to be mentioned in the public debate, it is all driven by our primary duty, to protect the interests of energy consumers, both now and in the future. Observing all of this activity over the last 12 months I have also been struck, once again, by the extremely high levels of ability and commitment shown by Ofgem's staff.

The other complaint I mentioned initially is that Ofgem's own activities in recent years have been a major factor behind the current problems in the market. The claim is that the market was working well until about 2008 following which Ofgem started to interfere and things went wrong as a result.

Well, first of all, I don't think you can say that there were no problems before 2008.

There has been evidence since the early days of retail competition that it was difficult for new players to enter the supply business and to grow their business once established. There are numerous potential explanations for this. These include the complexity of the network codes and market rules which govern participation in the market; the degree of risk and scale of capital requirements for small players; and, perhaps, structural issues in relation to the vertically-integrated model of the Big 6 energy companies.

Suffice to say that independent players have found it difficult to establish themselves with any substantial share of the market. It's not so much the fact that there are only 6 large energy suppliers that is unusual; it's the very low proportion of the market held by independents, and this has been a persistent feature. Recent experience has been more encouraging, with one new supplier reaching the 1 million customer mark recently, but I would like to see this improvement sustained over a much longer period.

Second, Ofgem's actions in the retail market were addressing issues that had been clearly identified in consumer research. As door-step selling largely disappeared after enforcement activity by Ofgem the focus of switching activity moved to price comparison websites and this brought a new issue into focus – differentiation of tariffs or, putting it another way, tariff complexity. This is not necessarily a bad thing. Daunting complexity as seen by one consumer can be a range of interesting alternatives to others; and innovative product or price offerings are an essential feature of markets. But it does bring the scope for confusion, including deliberate confusion.

Ofgem research showed lots of evidence of consumers being confused and switching sites being overloaded by the range of tariffs on offer. MPs' post bags showed similar evidence and even David Cameron at one stage weighed in, in Prime Minister's Questions, with a demand for simplification. The trend towards complex pricing structures – sometimes rather inelegantly referred to as the confusopoly - is certainly not unique to the energy market. In fact it seems to be a feature of the modern world and it is one I would like to see the CMA look at. You may disagree with Ofgem's approach in this area but it's hard to argue that there isn't an issue to address.

I've mentioned complexity a couple of times and it might be worth taking a little time to talk about that. The energy sector is inherently complex, largely as a result of the need to balance supply and demand in real time over a national system. Demand varies substantially within the year and within

the day and supply has to be available to match that demand. Ensuring that this is the case largely explains the need for the complex system of market rules I mentioned previously.

But there are other aspects of increasing complexity. Some of these are reflected in our duties, which have expanded in number and in scope, giving rise to difficult trade-offs that have to be assessed and resolved. To competition and consumer protection have been added environmental objectives, security of supply and alleviation of fuel poverty.

This trend goes against the recommendations of the House of Lords Select Committee report on regulators in 2007 and the Principles of Economic Regulation published by BIS in 2011 – both of which argued for simplicity and clarity of regulatory duties - but a regulator is governed by statute and must respond to the duties it is given by parliament.

Environmental objectives have also led to growing direct government influence on the organisation of energy markets, particularly in relation to the choice of electricity generating technologies. This has created a difficult interface in market governance to which wholesale markets are particularly exposed. Again, this is not unique to the UK and it is difficult to find examples of overseas markets in which it has been handled with any great success.

Similarly, Europe now has an increasing influence on GB energy markets. As well as our duties under UK statute we are now a National Regulatory Authority with duties set out under EU law.

The trend to increasing complexity is not going to go away. The advent of smart metering and smart grids, and the resulting scope for the digital world to have the sort of impact it has already had on other sectors of the economy, should provide major benefits for consumers. But it will also bring further complexity to the industry's IT systems and its interface with consumers. Making sure the industry is ready for smart metering and a smarter market is one of the most important challenges facing the sector in the next few years.

More generally, the wider legal framework in which energy regulation now operates is very different from that in the early post-privatisation years. In particular, regulators are required to consult extensively, undertake impact assessments and set out fully the reasons for every decision. I'm not saying that these are intrinsically bad things but they all take time and make it difficult for a regulator to respond rapidly to developments in the market. We accept this challenge and we are challenging ourselves to be better at identifying occasions when we should take risks with our processes, perhaps accepting a higher risk of legal challenge, to achieve more rapid positive results for consumers.

So, to pull all that together, the world in which Ofgem operates has become steadily more complex. There isn't an option of simply reverting to a former world in which everything was fine. It wasn't fine – and, in any event, things have moved on and expectations of the energy companies and of energy regulation have changed.

But, to be clear, I am not saying that there is no scope for improvement in energy regulation. There is always scope for improvement. Mistakes have no doubt been made, as they were in the past and no doubt will be in the future. That is almost inevitable when dealing with complex issues. The important thing is to correct mistakes in a timely fashion and to learn from them, with a view to

reducing the likelihood of making similar mistakes in future. That is important for Ofgem, as it is for the energy companies and for government departments.

I believe the CMA has an important role to play in this process of learning and improvement. One thing that struck me forcefully when I came back to Ofgem was the perceived wisdom that Ofgem had not been very good at using its competition powers. That surprised me at first because Ofgem had been very active in using competition powers in some respects - most notably in addressing abuses in the connections market and in gas metering.

However, I think it probably is fair to say that Ofgem has been reluctant to engage with the other authorities to whom Parliament has given a role in promoting competition, protecting consumers and improving market governance in the energy sector.

One thing that clearly did happen in the period after 2008 is that Ofgem decided to go down the route of regulatory intervention in the energy supply market rather than referring it to the competition authorities.

There were good reasons for this:

- concerns about the impact a market reference could have on investment, and hence on security of supply, particularly in the turbulent conditions following the 2008 financial crash;
- concerns about fairness and Ofgem's duties to protect vulnerable customers (issues which might be better addressed by regulatory measures);
- and perhaps a response to a change to Ofgem's duties, introduced in the 2010 Energy Act, which specifically requires us, before using competition measures, to see if any other approach would better promote the interests of consumers.

But I think there is also a risk that regulators fear losing control if they hand responsibility to the competition bodies.

My personal view is that it would have been better to refer the market to the Competition Commission at an earlier stage. This would have allowed a wider examination of the features that may be reducing the effectiveness of competition in the sector.

More generally, as I have argued, the issues facing the energy sector are complex and addressing complex problems should benefit from the insights of a fresh and independent second pair of eyes.

Ofgem is now positively seeking those insights and the contributions that the CMA can potentially make to the development of energy markets that work well for the long term interests of consumers.

Turning now to the future, I very much hope that, at the end of the CMA investigation, we will see a reaffirmation of the principles of independent regulation, perhaps reinforced to provide better future protection against some of the erosion of those principles that has taken place under the pressures that the current arrangements have faced in recent years.

I believe the arguments for independent regulation are clear. I thought Stephen Littlechild captured the essence of them elegantly at an event I was involved in last year when he said simply that the purpose of independent economic regulation was to protect consumers from exploitation by the privatised companies and to protect investors in those companies from interference by government.

The deal underpinning independent regulation should be that Parliament delegates specific tasks to an expert body; that body, the regulator, can say no if the executive arm of government seeks to undermine that delegation; companies play their part by not running to government whenever they disagree with the regulator's decision; and the regulator does its utmost to operate as an expert body and to remain impartial to the interests of the industry it regulates.

If this works as I have just described, there are advantages all round. Government should feel less need to intervene; companies should have the confidence to plan long term investment, the cost of capital to finance such investment should be reduced and consumers should gain.

I think it should also go without saying – but I'll say it anyway – that for independent regulation to be effective, the regulator cannot place itself in an ivory tower. Independence does not mean splendid isolation. The regulator needs to be engaged with and responsive to the experience of consumers, the concerns of the public and the business realities of the energy industry.

Independent regulation has worked well in some aspects of the energy business, most notably in the gas sector where independent regulation can claim much credit for the establishment of an effective wholesale market through the break-up of the British Gas monopoly on purchases from North Sea gas fields. This led to prices which compare well with the rest of Europe; a substantial contribution to decarbonisation through the displacement of coal-fired generation; and a major investment programme in pipelines, import terminals and interconnectors to assist with the replacement of declining North Sea gas production.

The ideal picture of independent regulation I have described is of course difficult to achieve, particularly against a background of substantially rising prices, but it is an ideal worth striving for. If the CMA process helps to get us closer to that ideal and to a position in which all parties stick to their part of the bargain I outlined, that will be very good news for British energy consumers.