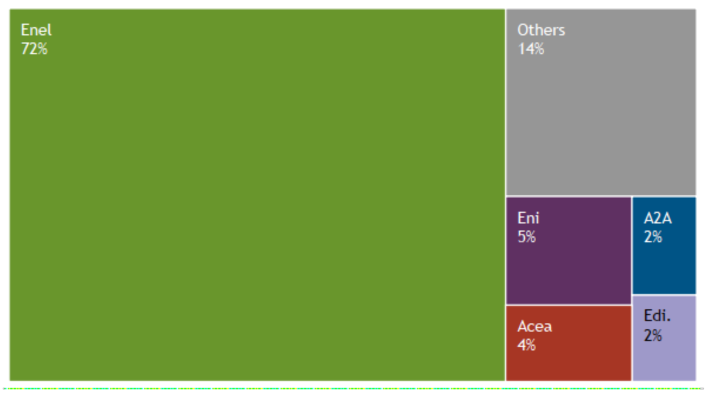
Ofgem, price caps, and the dangers of Italian design

Blog post by Practice Lead Matthew Duhan, 9 October 2017

Prime Minister Theresa May restarted the UK energy bills debate last week, announcing a draft Energy Bill which would allow Ofgem – the UK national energy regulator – to cap household energy bills in the form of the time-limited introduction of a ‘safeguard tariff’. While the GC energy practice watched from afar in Rome, some unexpected lessons from the Italian market emerged in discussions we were having with Italian policymakers and market participants.

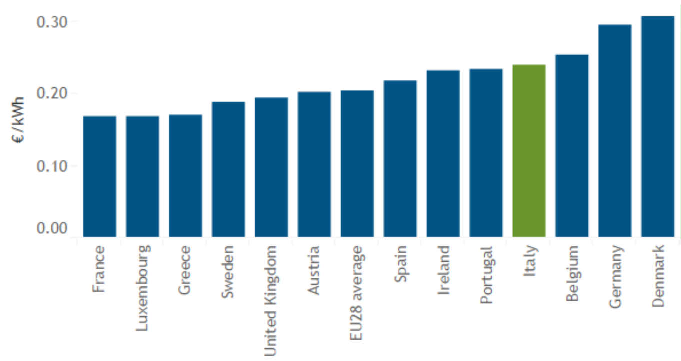
Superficially, the UK and Italian domestic retail energy markets are poles apart. While the UK has one of the most liberalised markets in Europe, two thirds of Italian households remain on tariffs set by regulator AEEGSI. Those in the UK who complain of the ‘dominance’ of ‘The Big 6’ utilities might be thankful they are not Italian, where state-controlled incumbent Enel supplies over 70% of the domestic market. Partly as a result, Italian households face among the highest electricity prices in Europe.

Italian domestic retail market share, 2015



Source: AEEGSI

Average 2016 electricity price for medium sized households



Source: Eurostat

Concern over UK energy bills are focused on the prices of ‘standard variable tariffs’ (SVTs), typically higher priced contracts onto which suppliers place household customers when their lower, fixed price contracts end. But while the UK government is cautiously edging towards intervention in the market to solve its bills problem, the Italian government is embracing liberalisation, with the ambitious target of removing the regulated tariff by 1 July 2019.

To date, progress in Italy has been slow, largely because few market participants can compete on price with the Acquirente Unico (‘single buyer’) which buys power in the wholesale market before selling it on to suppliers such as Enel who then supply households at the regulated tariff rate. In addition, few tariffs offered in the free market include additional services to compensate for higher prices. In any case, switching supplier costs money, and is both complex and time-consuming. With the regulated tariff generally coming out both cheaper and simpler than the alternatives, there is little incentive to switch.

In the UK, Ofgem has the unenviable task of designing a market intervention which satisfies the political appetite for action, without sacrificing the benefits of competition. As the UK highlights, too little regulation, and certain parts of the market – typically those in the lowest income brackets who do not actively engage with the market – appear to lose out in favour of those active, digitally savvy and typically middle-class consumers who search out the best deals. But as the Italian example demonstrates, too much action to cushion those on default tariffs drains competition from the market, ensuring that, overall, everyone ends up a loser.

In designing the safeguard tariff to protect inert consumers, Ofgem must answer the difficult question of whether it is set with a 'fairness' guarantee – that customers will not be charged more than other tariffs – or it includes some kind of disincentive against remaining on it, i.e. higher prices. And, while the UK government intends the safeguard tariff to be time limited, if it proves too successful, they – like their Italian counterparts – may find there is little appetite for its dissolution. It is a neat coincidence that the percentage of those on SVTs in the UK (66%) is nearly identical to those on regulated tariffs in Italy (64%). Although they are approaching it from different directions, British and Italian policymakers are struggling to design solutions to much the same problem.