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CAPITALISM FOR THE LITTLE GUY

10 WAYS TO EXTEND COMPETITION AND STRENGTHEN CONSUMER CLOUT

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SUMMARY

This report advocates the extension of competition policy to further widen consumer choice and reduce costs in five sectors: energy, water, retail banking, schools and health.

In energy, the Government should:

- phase out state-backed subsidies for renewable energy technologies, reducing energy bills for businesses and homes;
- support the development of a secure web-based account switching facility;
- encourage energy companies to sign up to the online account switching facility through a temporary tax break.

In the water industry, the Government should:

- require the legal separation of the retail and supply arms of the water companies, paving the way for the extension of retail competition in both the non-household and household sectors.

In retail banking: the Government should:

- require banks to provide retail customers with clear detail about all charges;
- require portable accounts to facilitate account switching by customers;
- overhaul the process of licensing new retail banks;
- give the Financial Conduct Authority a specific mandate to promote competition.

In education, the Government should lift the bar on profit-making companies running academies and free schools, subject to:

- a minimum of 50% of profits being reinvested into the school;
- a requirement that dividends only be paid if certain educational performance standards are met; and,
- a bar on the sale for commercial gain of school assets purchased with public money.

In health, the Government should:

- level the playing field between public and private sector service providers, in recognition of the high extra costs private providers face because of pension liabilities, corporation tax and VAT.

1. INTRODUCTION

The free market has long been associated with the profit motive, business growth and job creation – while its detractors criticise the unfairness of leaving the market to decide socio-economic outcomes. However, a crucial benefit of the free market system is the extent to which it empowers customer choice, putting the consumer – not big business or other monopolistic forces – in the driving seat. To ensure a level playing field, the system needs smart rather than over-intrusive regulation, so that effective competition is not stifled by deep-rooted oligarchic incumbents or groups, price-fixing or other collusive or restrictive practices.

Many of the recent criticisms of big business or privatised industries stem from some degree of failure to ensure or implement that level playing field. Rising rail fares are the result of, at least in part, a byzantine regulatory framework and a dysfunctional market for rail users. High energy bills reflect a range of environmental subsidies and tariffs that artificially inflate prices, and difficulties in exercising consumer choice between energy companies. Many of the problems in the UK banking sector derive from a market dominated by a small number of banks deemed "too big to fail", which have restricted customer choice and created barriers to new entrants to the sector in a range of subtle but decisive ways.

This report sets out a range of practical policy proposals to extend competition in both the private and public sectors – in energy, water supply, banking, education and health. The aim is to promote innovation and expand consumer choice. The result would be to increase competition, broaden consumer choice and to help reduce prices on a range of goods and services.

2. COMPETITION AND GROWTH

There is widespread evidence of the impact of competition policy on economic growth. It is associated with productivity gains resulting from reduced barriers to market entry, increased innovation and diversified market shares.[1] In 2007, the UK Office of Fair Trading (OFT) published a report highlighting the links between increased competition and gains in managerial efficiency within companies, innovation as a result of higher flows of new entrants to the marketplace, and technological improvements in processes and products.[2]

In 2011, the OFT followed up its earlier report with an analysis reaffirming the link between competition policy and economic growth and competitiveness, drawing on the experience of UK market liberalisation throughout the 1990s.[3] The narrowing of the productivity gap between UK and German manufacturing was also attributed to increased UK competition. Strengthened competition was also cited as the reason for the dramatic reduction in the costs of budget air travel and long distance telephone calls, and lower priced medicine in the retail pharmacy sector.

Similarly, the Organisation for Economic Cooperation and Development (OECD) has provided an international perspective on the gains from UK liberalisation during the 1990s, in particular finding that:[4]

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1 See, for example, Stephen J Nickell, "Competition and Corporate Performance", *Journal of Political Economy*, August 1996; and Aghion, Blundell, Griffith, Howitt and Prantl, "The Effects of Entry on Incumbent Innovation and Productivity", *The Review of Economics and Statistics,* 2009.

2 OFT, *Productivity and Competition*, 2007.

3 OFT, *Competition and Growth*, 2011.

4 Maher and Wise, *Product Market Competition and Economic Performance in the United Kingdom*, OECD 2005.

"A sectoral comparison of labour productivity growth shows that the United Kingdom had the highest productivity growth of the G7 countries in construction and phenomenal rates in electricity, gas and water, where annual productivity growth averaged just over 10 per cent a year, primarily due to liberalisation and regulatory reforms undertaken in electricity and gas over the past decade."

In its 2011 report, the OFT recognised the linchpin role played by consumers in such liberalising measures. In particular:[5]

"The positive impact of competition on economic growth can be furthered by empowered consumers, with clear synergies here between competition and consumer policy. When consumers trust firms and markets (because of consumer protection) and when consumers actively choose and buy what is best for them (with the aid of consumer protection), then firms will compete fairly to deliver what consumers want, in order to gain business from each other."

The report added that:

"Active consumers with the confidence to engage in markets will, in turn, act as a driver for economic growth. Firms can only gain from innovation if consumers are active and willing to adopt these new products. In this respect, consumer protection can ensure that competition results in the 'right' kind of innovation, aimed at addressing consumer demand and improving processes, not at obfuscating consumers… consumer policy has a role in the protection of vulnerable people, which can be hugely important, especially in times of economic uncertainty when consumer confidence can dampen demand."

In 2004, a Department of Trade and Industry research paper documented some of the specific gains to consumers across a range of illustrative sectors.[6] It found reduced costs as a result of deregulation of international telephone calls, abolition of book prices, liberalisation of European aviation markets and financial penalties imposed for price fixing of replica football kits.

In addition to government de-regulation, increasingly active consumer organisation has also driven bottom-up competition. The consumer magazine *Which?* has been particularly active, highlighting value for money across the energy, broadband and banking sectors.[7]

In this way, competition policy is not merely some abstract economic theory, dislocated from ordinary people buying goods and services in their daily lives. Nor is it limited to incentivising the conduct of large – and smaller – businesses. Where carefully designed, properly implemented and rigorously enforced, competition enables consumers to get the best out of the market through lower prices and wider choice.

The following analysis looks at five sectors – energy, water, banking, education and the NHS – that are ripe for the further expansion and enforcement of competition.

5 Ibid, footnote 3, at p 8-9.

6 Davies, Coles, Olczak, Pike and Wilson, *The Benefits from Competition: some illustrative UK cases,* DTI, 2004.

7 See Which?, *Annual Review*, 2010/11.

3. THE ENERGY SECTOR

Rising energy bills are a major pressure on low and middle income families. Whilst fluctuating international fuel prices have a substantial influence on households, domestic bills are also artificially inflated by anti-competitive factors in the UK.

Scrap Subsidies, Cut Bills

The costly and inefficient state-imposed tariffs and subsidies, designed by the last Government, hike prices, distort competition and stifle choice. Between 2010 and 2014, the estimated annual cost to businesses and homes of subsidising energy companies to produce solar, wind and hydro-electric power – under the Renewables Obligation (RO) – is set to double, topping £2.5 billion and costing each household the equivalent of £97 per year.

At the same time, Feed-in-Tariffs (FITs), the subsidy paid by consumers to encourage small businesses and homes to generate renewable power, will quadruple in cost between 2011/12 and 2014/15 – hitting £790 million.[8]

The total cost of the FITs scheme in its first year of operation (2010/11) was £14.5 million.[9] Figures released by Ofgem in December 2012 reveal that, in 2011/12, the cost had risen by almost ten times to £150.8 million.[10] As of 31 March 2012 (the most recent date for which information is available), solar installations accounted for 92% of total installed capacity under the FITs scheme – and received a subsidy of £128 million.[11]

Despite adjustments to the FIT rates, to take account of much higher than expected demand, the cost to consumers is still forecast to exceed the budget by over £1 billion between now and 2015.

8 DECC, *Consultation on Feed in Tariffs for solar PV,* 2012.

9 Ofgem, *Feed in Tariff: Annual Report 2010/11,* 2011, p. 5

10 Ofgem, *Feed in Tariff: Annual Report 2011/12,* 2012, p. 24

11 Ibid., p. 15

TABLE 1: COST PER HOUSEHOLD OF RENEWABLES OBLIGATIONS

	2009/10	2010/11	2011/12	2012/13	2013/14
Cost (£ million) of Renewables Obligation*	1,121	1,285	1,457	2,019	2,583
Millions of UK households †	25.8	26.0	26.3	26.5‡	26.7
Equivalent cost per UK household, £	43.42	49.42	55.52	76.29	96.84

* Calculated by multiplying the size of the RO (in Megawatt Hours) by the Buy Out Price (£). The 2013/14 Renewables Obligation has been set at 61.5 million ROCs (announced 28 September 2012). The Buy Out Price for 2013/14 has not yet been announced. It rises in line with RPI inflation. For 2012/13 it was set at £40.71. Accordingly, it can be expected to be close to £42 for 2013/14 (HC Library figures).

† ONS, *Families and Households series*, Table 7, 2011.

‡ There is no figure for 2012. The figure is calculated by taking the DCLG projection of the total number of UK households in 2013 (26,674,000) and halving the difference between this and the 2011 figure.

TABLE 2: COST OF FEED-IN TARIFFS (FITs)

	2011/12	2012/13	2013/14	2014/15	Total
Cost to consumers: central scenario, £ million*	170	540	660	790	2,160
FITs budget, £ million	90	200	330	450	1,060
Deficit against FITs budget, £ million	-80	-340	-330	-340	-1090

* DECC, Consultation on Feed in Tariffs for solar PV, February 2012.

Are these subsidies for existing renewable energy sources a rational investment? As Table 3 shows, measured by load factor – the extent to which a plant operates at maximum capacity – the data is mixed, to say the least. Solar and onshore wind energy efficiency actually fell between 2009 and 2011. Offshore wind and hydro have improved marginally. This means some of the largest subsidies have gone to the least efficient renewable sources. This makes little environmental or economic sense.

The Energy Bill will phase out ROs. But the new Contracts for Difference (CfDs) will impose a massive consumer cost of £7.6 billion a year – which is three times the current level. In addition, existing FITs will remain in place.

The case for a thorough overhaul of these subsidies is compelling. None of the current renewable technologies, propped up by state intervention, can make a major difference to UK energy supply in the foreseeable future. They are expensive, with businesses and ultimately consumers paying far higher energy bills as a result. Furthermore, they make little difference to the UK effort to decarbonise its economy: as production emissions have fallen, consumer emissions have commensurably risen. And they warp the market by attracting investment into inefficient technologies.

Phasing out these subsidies would reduce energy bills substantially, and remove a major source of artificial distortion of the market for renewable technologies.

This does not mean giving up on renewables, nor does it mean that government has no role to play. However, if we want to back the low carbon technologies of the future, government should spend less money trying to pick commercial winners, and more promoting genuine scientific innovation. In 2011, government investment in energy research and development was just 6% of the RO and FITs subsidy – and less than that seen in France, Germany, the US, Canada and Japan.

Empower consumers

In addition to the flaws in the current state subsidies, energy companies have themselves been widely criticised for overly complex tariffs and year-on-year price rises. Domestic gas and electricity prices rose over the last eight years, after a decade of falling prices. Last year, the six big UK energy suppliers increased their prices over inflation, by between 6% and 11%. Meanwhile, a *Which?* survey of 10,000 members of the public saw none of the big six ranked above ninth place for customer satisfaction – despite accounting for 98% of the market.[12] In addition, Ofgem reports that the number of energy tariffs has increased to over 400, creating a confusing array of options for consumers.[13]

12 *Which?* survey, 22 January 2013.

13 Ofgem, *Retail Market Review – Findings and Initial Proposals,* 2011.

TABLE 3: LOAD FACTOR BY TECHNOLOGY

Technology	Load factor 2009*	Load factor 2010	Load factor 2011
Solar Photovoltaic	9.3%	7.3%	5.5%
Onshore Wind	27.4%	21.7%	27.3%
Offshore Wind	26.0%	30.4%	36.8%
Hydro-electric Power	36.7%	25.4%	39.1%

* Information on the Load Factor for different technologies comes from DECC, Digest of UK Energy Statistics (2012), Table 6.5, Load factors for renewable electricity generation.

In its 2011 review, the statutory consumer watchdog, Consumer Focus, reported that 35% of consumers did not understand their energy bills, and 75% found them confusing.[14] The complexity has led to poor customer service, with uSwitch reporting that 25% of households have been incorrectly billed by their energy company within the last two years.[15]

In response, the Government announced proposals to:

- limit suppliers to four core tariffs,
- require suppliers to offer a single price for each of the four tariffs, and
- impose a duty on companies to switch customers from 'dead' tariffs to their cheapest rate.[16]

The proposals for improving transparency and reducing the number of tariffs are welcome. However, there is a countervailing risk that stipulating that all customers be switched to a prescribed minimum rate may lead to companies increasing the minimum – or other – rates.

Meanwhile, some consumers are organising themselves in an attempt to maximise their bargaining power with the energy companies. In May 2012, consumer magazine *Which?* helped co-ordinate 'The Big Switch', a reverse auction that enabled energy companies to bid for the group custom. Five suppliers signed up to take part, and Co-operative Energy won. It led to 38,000 consumers switching energy supplier, with an annual average saving of £223 on energy bills.

This kind of initiative is catching on – not just among consumer organisations, but also local authorities. Surrey County Council is currently coordinating its own collective 'Switch and Save' programme, which has already attracted more than 3,000 participants.[17] This follows a similar project led by the Greater Manchester Combined Authority, representing ten north-western councils.

Such consumer-driven collective switching has various attractions. It can enable the concentration of consumer power to promote greater competition in the energy market and reduce prices. It could also encourage new entrants to the market, by creating a critical mass of customers who are easily biddable.

Which? argues that:[18]

> *"Non-switchers often state that the reason for their lack of engagement with the market is 'too much hassle' – and we know from our web analytic figures from both Which? Switch and the Big Switch that a significant number of people drop away when faced with the request for information from their bill. Furthermore, numerous people who try to input energy bill information into switching sites – including collective switching schemes – enter information that is either incorrect or incomplete.*
>
> *Providing a facility for switching sites and collective switching schemes where consumers could switch without a bill could reduce the hassle factor and drop off rates, and lead to an energised market."*

[14] *'Missing the Mark'*, Consumer Focus, June 2011.

[15] Press release, *uSwitch*, 12 April 2012.

[16] *'Ensuring a better deal for energy consumers'*, DECC, 2012.

[17] *'Surrey's Collective Switching Scheme'*

[18] Which? briefing on the Big Switch, provided to Dominic Raab MP on request, December 2012.

The challenge is to create a switching facility that is easy to use and capable of attracting large enough numbers to make it worthwhile for energy companies. The Government is encouraging a voluntary initiative across business – not just energy companies – known as "Midata". Midata will mean companies and organisations are obliged, on request, to provide the data they hold on consumer transactions in an easy-to-read and reusable electronic format, allowing consumers to make informed choices about whether they are receiving value for money from service providers, and whether they could obtain a better deal elsewhere.

According to uSwitch:[19]

> *"It takes on average 17 minutes for customers to switch with uSwitch.com for savings of up to £420, however focus groups continue to suggest that many deem this not worth the hassle. Midata offers a solution to overcome these barriers; removing the need for customers to decipher their energy bill, providing an accurate method for price comparison and allowing consumers to access this information at the click of a button. This could prove a vital tool in encouraging the 6 in 10 households who have never switched to find a better deal."*

So far, 20 companies – including the Big Six energy companies – have undertaken to work towards the Midata principles.[20]

According to the Department for Business, Innovation and Skills (BIS), the Midata initiative will continue as a voluntary project in the short term and the Government will seek to accelerate progress by broadening the sectors that are engaged.[21] The Government will use primary legislation to give itself a reserve power to impose a duty on businesses to cooperate in the future – if it deems it necessary to do so.

There are two key factors to making the voluntary approach work. First, it is important to ensure that the proposals attract a sufficient volume of customers to wield effective bargaining power. In this regard, there have been concerns expressed regarding the industry-led proposal. uSwitch has cautioned against aspects of the current model under development by the energy sector:[22]

> *"The current [Energy Retail Association] proposal would allow a customer to download their energy data into a csv file which they would then be required to upload to a comparison service. We believe that the introduction of an additional step in the customer comparison journey will limit the success of this initiative. It will significantly reduce any time-savings to be gained from the customer's perspective and they will be required to interact with numerous different applications which removes the promise of ease of use. Implementing Midata in this way could potentially go as far as to introduce a new barrier to effective engagement in the switching market – computer literacy – and further distance many of the demographics who have the most to gain from this proposal.*

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19 *uSwitch* consultation response to Energy Sector Board Draft Proposal on Midata.

20 Written Parliamentary answer by Jo Swinson, 9 January 2013.

21 BIS, '*Midata: Government response to 2012 consultation*', November 2012.

22 *uSwitch.com* consultation response to Energy Sector Board Draft Proposal on Midata.

A webservice is required to realise the full benefits for consumers. We would like Energy suppliers to provide an authenticated web service that lets uSwitch access customer and consumption data on their behalf. Similar platforms already exist, such as Facebook and Twitter, and provide a trusted way for consumers to share their data with third parties. Importantly, these platforms use open, standard protocols that increase their security and minimise integration costs…

…We believe programmatic services from Energy suppliers using existing protocols would provide the best experience for customers: a familiar way of sharing their data, choice over who to share their data with, and control of what they share. We also believe it provides the best experience for application developers looking to integrate energy data into their applications. As raised in previous Energy Sector Board meetings we would be very keen to work with ERA to develop a full technical solution."

There are sound arguments for developing a web-based solution, which would result in a simpler, speedier and safer consumer experience.[23] The Government should back the idea in its engagement with industry.

Second, a countervailing risk with any voluntary approach is that too few companies implement Midata. Rather than relying exclusively on the stick of threatening to make the scheme mandatory, the Government should also offer the carrot of a tax incentive focused on the energy sector. This would be a temporary tax break, over two years, for those energy companies that implement a web-based Midata scheme, approved by industry, Government and the Information Commissioner. It could be delivered as a further cut in corporation tax, or an increase in investment allowances. The cost should be funded from BIS's existing budget, or alternatively covered by savings in capital and administration costs delivered from merging the Departments for Energy and Climate Change and Environmental and Rural Affairs.[24] It should be set at a level to cover the costs of the migration to Midata and provide a meaningful financial incentive for energy companies to sign up.[25]

4. THE WATER INDUSTRY

Expand customer choice, promote innovation

Of all the privatised public utilities, the water sector remains one of the least open to competition. Recent increases, and wide regional variations, in water bills have attracted criticism from consumer groups and businesses.[26]

Currently, the water sector in England and Wales consists of 21 regional monopoly water companies. These companies provide a 'source to tap' service for both domestic and non-domestic customers in their area: obtaining water from source, treating it to an appropriate standard, and providing it to customers' taps via company-owned

[23] The Information Commissioner's Office has been involved in developing the Midata initiative, bearing in mind concerns over data protection.

[24] This proposal, to save £1 billion per year, is considered in further detail in Dominic Raab, *Unleashing the British Underdog*, Centre for Policy Studies, 2012.

[25] According to the BIS Impact Assessment, the estimated one-off cost of setting up Midata is £670,000 with annual costs thereafter of between £800,000 and £2 million. Corporation tax paid by the energy sector in 2010/2011, the latest year for which data is available, amounted to £9 billion.

[26] Average annual bills rose by 5.7% in April 2012, ranging from 3.8% at Dwr Cymru to 8.25% at Southern, reported by BBC News online, 31 January 2012.

infrastructure. The water sector was privatised in this way because water distribution networks are regional, with each water company area having a dedicated pipe network and water supplies. These networks are only weakly connected to other areas. Ofwat, the water regulator, was created to control what these monopolies can charge customers. It sets water bills for customers through its Price Review process.[27]

There is some limited competition in the current system. Some groups of users and those consuming large amounts of water can choose their supplier through Inset appointments (introduced in 1990) or the Water Supply Licence regime (introduced in 2005). However, this is confined to large scale customers of water (over five megalitres per year – the equivalent of filling two Olympic-sized swimming pools) and has rarely been used.

In 2011, the Department for the Environment, Food and Rural Affairs (DEFRA) concluded:[28]

> *"The regime has not worked well. Restricting the ability to switch – to very large users – has meant the competitive market is too small to develop effectively. Barriers in legislation make the market unattractive to new entrants and have frustrated customers that want to switch suppliers. Only one customer has changed suppliers in six years."*

Given the failure of the existing arrangements to deliver competition, the last Government commissioned Professor Martin Cave to lead an independent review of competition and innovation in water markets between March 2008 and April 2009.[29] The Cave review recommended a range of regulatory changes in the sector to promote competition.

Professor Cave recommended reform of 'upstream' competition. This would allow competition in the supply of raw or treated water into a water company's network, or the removal of waste water or sewage for treatment. Charges relating to 'upstream services', i.e. the sourcing and treatment of water and the disposal of sewage, account for about 40% of the bills customers pay.[30] Currently the Water Supply Licensing regime does not permit licence holders to provide solely upstream services but requires them to provide a retail service as well. This may discourage new entrants who could provide competitive upstream services but do not wish to deliver retail services (and *vice versa*). Following the recommendations of the Cave review, the Government's new draft Water Bill will 'unbundle' these licences so that new entrants can sell raw or treated water into an incumbent's network, or remove and treat waste water from a network, without having to also provide retail services. New entrants will also be able to access water companies' treatment and storage systems (rather than just their mains and pipes) and hold a new network licence which will allow them to own and operate their own infrastructure, which they can connect to an incumbent's network. The Government states that the benefit to the UK economy could be as high as £3.4 billion, with the 'best estimate' being £2 billion over 30 years.[31]

27 The next Price Review (for the period 2015-20) will take place in 2014. A further 3.5% average rise was announced in February 2013, including a 5.3% increase for Southern customers and a 5.5% increase for customers of Thames Water.

28 DEFRA, *Water for Life white paper*. 2011, p. 68.

29 Professor Martin Cave, *Independent Review of Competition and Innovation in Water Markets*, 2009.

30 Ofwat, *'Upstream market reform'* briefing note, 2012.

31 HM Government, *Draft Water Bill.*

The Cave review also proposed introducing 'retail' competition for non-household customers. Retail competition involves allowing water companies to compete with each other to provide the retail part of water bills. The retail part covers the cost of customer care, billing and meter reading, and comprise about 10% of the total value of water delivered.[32]

Under the new system, water companies would be permitted to purchase water from the incumbent water company, and then sell the water to customers in that area. If a company can make savings to the retail part of the bill, they can compete on price. The Cave review estimated that a move to retail competition could deliver savings of £600 million over 30 years.[33] As well as giving businesses greater choice, it would allow companies with a nationwide presence to opt for a single national retail service – and single water bill – rather than fragmented regional ones.

To support this measure, Professor Cave recommended the 'legal separation of both the household and non-domestic retail arms of water companies from the remainder of the appointees' business'. He argued this would help improve efficiencies, promote customer service, reduce costs, and benefit the environment.[34]

In fact, non-household retail competition has already been introduced in Scotland in 2008. Since then, more than 45,000 business customers have renegotiated the terms of their contracts and are enjoying a range of benefits due to the more competitive market. Accountancy firm Grant Thornton estimated that customers in Scotland would save £110 million over the next decade, reflecting savings from lower unit prices (£60 million to 70 million) and savings from lower water use (£50 million to £55 million). The ability for new suppliers to offer more tailored services to its customers has led to, for example, the Scottish public sector being forecast to save £25 million over three years from discounts to prices and new water efficiency measures.[35]

The Government's draft Water Bill would eliminate the consumption threshold on business supply, enabling all non-household customers to switch the water company they use. However, the proposals in the draft Water Bill apply only to non-household customers, and there are no immediate plans to extend competition to household customers in the foreseeable future.[36] But Ofwat argues that introducing retail competition for non-household customers will help companies learn lessons and practices which can make their services to household customers more efficient (for example, with respect to wider billing practices). In addition, in principle, Ofwat also supports introducing household retail competition at some point in the future.

The draft Water Bill does not contain the Cave review's recommendation that the retail and supplier arms of water companies be separated, with the Government arguing it would risk unduly unsettling investor confidence.[37] However, Ofwat supports full legal separation, because without it 'incumbent water, sewerage or water and sewerage service providers would have both the incentive and opportunity to discriminate in favour of their own vertically integrated retail arms, thereby stifling the benefits from that

[32] House of Commons briefing note, December 2012.

[33] *Independent Review of Competition and Innovation in Water Markets,* 2009, p 8.

[34] Ibid, p. 76.

[35] Ofwat, *Introducing retail competition*, 2012.

[36] DEFRA, *'Water for Life white paper'*, 2011, p. 70.

[37] Ibid.

competition'.[38] This conclusion was also recently endorsed by the House of Commons Environment, Food and Rural Affairs Select Committee.[39]

In addition to removing barriers to entry, legal separation would remove barriers to exit. Ofwat argues that full legal separation is desirable because it would allow incumbent providers to exit the retail market, which – assuming there is a more competitive alternative retail provider – can also work in consumers' favour. Currently, the licence requires them always to offer retail services, even if it is inefficient for them to provide them, for example, because they have a small number of non-household customers and retailing services to those customers may be better provided by a larger firm that can take advantage of scale economies in billing and other retail activities. Ofwat estimates that, of the 21 current water companies, between seven and eleven are likely to be operating below 'minimum efficient scale', and there appears to be considerable scope for merger and consolidation of existing companies in retailing to return benefits to consumers.[40] Ofwat also estimates that full legal separation 'could conservatively increase the benefits of these reforms by some £200 million.'[41]

Similarly, public utilities expert, Dr Simon Less, argues:[42]

> *"It is the combination of legally separating water companies' retail businesses (including both households and non-households) and enabling non-household customers to choose their retail services supplier that would drive the benefits through."*

According to Dr Less, those benefits include increased productivity, improved customer service, environmental benefits from saving water, reduced costs and spill-over efficiencies that benefit the household market. Dr Less also highlights evidence from the Cave review that shows these benefits may be delivered relatively quickly: one quarter of customers in Scotland benefited from prices below default levels within months of the non-household retail market opening there in 2008.[43]

The Government's caution in extending competition in the public utilities is understandable, given the degree of commercial uncertainty and political sensitivity. However, there is a real risk that failure to separate the retail and supply arms will undermine the benefits to businesses of existing proposals to extend competition to the non-household retail sector. It is, therefore, proposed that the draft Water Bill be revised to include the legal separation of the retail and supply arms of water companies in both the household and non-household sectors. This would ensure the expected gains from extending competition in the non-household sector can be realised, whilst paving the way for a further future extension of competition into the retail household sector. Furthermore, there should be an automatic review within five years of the enactment of the Water Bill, to consider the experience of implementing the legislation in relation to the non-household sector, with a

38 Ofwat, '*Review of the evidence base for retail competition and separation*', 2011.

39 House of Commons Environment, Food and Rural Affairs Select Committee, *Sixth Report of Session, 2012/13,* 2013.

40 Ofwat, '*Allowing retailers to exit the market or merge*' briefing note, 2012.

41 Ibid.

42 Dr Simon Less, '*Water retail service competition in England and Wales*', Policy Exchange, July 2011, p 2.1.

43 Ibid, p 27.

view to extending retail water competition to domestic customers. The Government should indicate its positive intention to expand competition into the domestic retail sector in due course, unless there emerge countervailing reasons not to, thereby giving the industry greater clarity of direction and time to plan accordingly. Taken together, these measures would increase upstream and retail competition, expand customer choice and lead to savings and greater convenience for business and, in due course, household customers.

5. RETAIL BANKING

Empower consumers, break the cartel

There has been no shortage of criticism of UK banks recently – from bankers' bonuses to poor customer service and onerous charges. Many of these issues are linked by shortcomings in transparency, limited customer choice and the uncompetitive state of the UK banking sector in the aftermath of the financial crisis.[44]

Retail bank customers have only a minimal idea of how much they are charged for services and products, and banks are widely mistrusted. Customer service is poor. Britain's banks receive 10,000 complaints per day. According to a recent *Which?* survey, 59% of customers would switch account if it was easier to do so.[45] Poor service is compounded by deficient IT systems, illustrated by the computer breakdown at RBS in 2012 that blocked account access for millions of customers.

At the same time, the number of big players in the retail banking market has shrunk dramatically. According to the British Bankers' Association, the number of major UK banks virtually halved from 41 to 22 between 2000 and 2010 (the total number of regulated deposit-taking banks fell from 420 to 332). There have been 14 mergers since 2008 – including the merger of Lloyds TSB and HBOS. The big four – RBS, Lloyds, Barclays and HSBC – control 78% of the current account market, yet they are some of the least popular banks with customers.[46]

An extension of competition in the retail banking sector would empower customers to exercise genuine choice, hold banks to account, improve service and create a more competitive range of products and prices. Currently, just 2% of bank depositors switch banks each year.[47]

The first thing customers need is information – including a regular estimate of the charges they pay on deposit, current or other debit accounts. The OFT has prompted the banking sector to take modest steps in the right direction.[48] But there is still no comprehensive and regular provision of information on bank statements, explaining in a clear format regular account charges, transaction charges, as well as interest foregone by way of charge. Provision of such basic information should now be made a regulatory requirement.

44 For recent consideration of these issues, see, for example, Andrew Tyrie, *Greater Transparency for UK retail banking*, CPS, 2007; Andrea Leadsom, *Boost Bank Competition*, CPS, 2011; Andrea Leadsom, *Driving Banking Reform*, Free Enterprise Group, 2011; and Tim Ambler and Eamonn Butler, *Simple Rules for Complex Systems*, Adam Smith Institute, 2012.

45 *Which?*, September 2012.

46 As reported by the House of Commons Treasury Select Committee report, *Competition and Choice in Retail Banking,* 2011. On customer service ratings, a survey of 13,000 people by *Which?* in 2011 found none of the large banks scored highly. First Direct, The Co-operative Bank, The One Account, Smile and Yorkshire Building Society topped the ratings.

47 Reported in the *Financial Times*, 25 October 2012.

48 See the Seventh Special Report of the House of Commons Treasury Select Committee, July 2011.

The second tool to put at the disposal of customers is choice. In 2011, the banking sector committed to guaranteeing that accounts would be switched – where requested – within seven working days by September 2013. However, it still remains unduly cumbersome to switch account, undermining the greatest leverage the consumer has. According to *Which?*, three-quarters of customers believe that the introduction of portable bank account numbers would make switching banks easier. The answer is to give customers a portable banking code, and require the banks to adopt a common IT system (also accessible to new entrants). The technology exists, although it would require a significant transition period and would require substantial costs to establish.[49] The banking sector should bear these costs as part of the post-crisis reform agenda, and the Bank of England should be tasked to oversee the transition.

This proposal appears to have drawn support from Andy Haldane, the Bank of England director responsible for financial stability. He recently told the Parliamentary Banking Commission that common banking IT could serve a 'central utility-type function' enabling new banks to 'plug and play', thereby boosting competition in favour of consumers.[50]

Banking transparency and consumer choice needs to be backed up by a third initiative, namely reducing barriers to entry in the retail banking sector.[51] In February 2013, the Chancellor announced plans to open up the banking payments system to new entrants, so that they no longer have to obtain access via one of the established banks. He explained, 'Asking your rival to provide you with the essential services you need at a reasonable price is not a recipe for success'.[52]

Reform of the payments system is welcome. However, we need to go further. Drawing on experience of local banks in Germany and Switzerland, removal of a range of other UK barriers to entry would help enable the establishment of more competitive retail banks. In addition to benefiting individual customers, improved competition would also help small and medium sized companies (SMEs) starved of credit by troubled bigger banks desperate to repair their balance sheets after the financial crisis.

A number of discrete policy measures would help. First, licensing of new banks by the Financial Services Authority (FSA) is unduly cumbersome, because opaque and moving deadlines create unnecessary uncertainty which deters investors. On average, new financial firms are waiting a record 21.6 weeks for a decision on approval.[53] Second, FSA scrutiny of applicant business plans has an in-built preference for a strong high street presence, which goes against the commercial grain (with many banks reducing the number of costly outlets), and imposes high costs on start-ups looking to draw on online or telephone banking to innovate more competitive products and rates for customers. Third, the FSA takes a conservative approach to personnel – favouring the appointment of

49 See Andrea Leadsom, *Driving Banking Reform,* Free Enterprise Group, 2011. The Treasury has made no assessment of costs, according to a written Parliamentary question answered by Sajid Javid on 24 January 2013.

50 Reported *Daily Telegraph*, 23 November 2012.

51 For a recent overview of the issue, see Stephen Clarke, *Street Cred – Local banks and strong local economies,* Civitas, 2012.

52 Speech by the Chancellor of the Exchequer, 4 February 2013.

53 Reported in the *Financial Times*, 25 October 2012.

existing banking executives.[54] Whilst experience is important, this approach risks entrenching an 'old boy' network and discourages new thinking. Fourth, the capital requirements expected of new banks are unduly high – based on the forecast balance sheet in five years' time – which discourages new entrants. Fifth, liquidity requirements – with specific regard to quickly acquired deposits, larger deposits and online account deposits – have the effect of deterring many new banks. Sixth, the lack of a common clearing system accessible to new entrants penalises prospective new banks.

Privately, many with experience of applying for FSA licensing are scathing about the process, claiming there is an unwarranted cultural bias that invariably concludes that too many banks are just 'too small to start'. Applicants are reticent about speaking publicly, for fear of entirely falling out of favour with FSA officials. Equally, the one new bank to successfully enter the marketplace – Metro Bank – reported that, owing to the regulatory hurdles, it only expected to break even in its fourth year of trading.[55]

Further reforms in each of the particular areas, identified above, would help reduce barriers to entry. Steps to overhaul the payments system between banks, facilitate account-switching, reform the FSA licence approval procedure, and adjust capital and liquidity rules for online or new deposits are necessary. In addition, as recommended by a recent report of the Treasury Select Committee, the new Financial Conduct Authority should be given a specific mandate to promote competition in the retail banking sector.[56] As the report states:[57]

> *"Competition should be central to the culture of the FCA. This is not for competition's own sake, but because effective competition benefits consumers."*

Taken together with new measures to ensure the orderly wind-down of failing banks without taxpayers bearing the costs – through bail-ins, living wills, and other measures – a more competitive regulatory framework would deliver better customer service, lower charges and wider customer choice.

6. SCHOOLS REFORM

Meet demand for places, expand parental choice

Given tight financial conditions, schools face huge pressure on capital funding under the Coalition's current Comprehensive Spending Review. Yet the number of primary school pupils is expected to increase by 14% rise by 2018.[58] In addition to this demographic pressure, 17% of parents in England in 2011 did not get their first choice, while any local surplus of places tend to be in poorer performing schools.[59] The supply of places in good schools remains a major policy issue.

The government's flagship schools policy – comprising academies and free schools – is

54 Evidence variously submitted to the Treasury Select Committee, as part of the Independent Commission on Banking, which reported 18 October 2011.

55 Reported in the *Financial Times*, 5 July 2012.

56 *Report on the Financial Conduct Authority*, Treasury Select Committee, 2013.

57 Paragraph 28, ibid.

58 Department for Education data, October 2011. The birth rate in England and Wales has increased by a fifth over the last decade, while net immigration has also added to demand. See ONS, Birth Summary Tables, England and Wales, 2010.

59 Laird, Wilson and Groves, *Social Enterprise Schools,* Policy Exchange, 2012.

addressing the challenge, giving teachers, parents and governors greater autonomy to innovate to meet local needs, while enabling private sector investment. On average, academy pupils do better than other maintained schools.[60] The evidence of improved educational standards of attainment from free schools in Sweden is now also very strong.[61]

In addition, Department for Education analysis also shows that between 2005/06 and 2010/11, pupils in academies with an external sponsor improved at a substantially faster rate than other schools, including other academies.[62] Charities and businesses have proved effective sponsors. They can harness expertise and secure access to additional resource streams. However, business investment in sponsoring academies and free schools is currently constrained by bars on them making a profit, which is particularly limiting for chains of academies that have proved especially effective at raising standards.[63] In other areas of the educational sector, profit-making businesses are already allowed to provide nursery education (for example, in special educational needs schooling and pupil referral units). Is there a case for modest, incremental, extension?

International experience suggests that enabling profit-making is an important element of raising standards. A majority of Swedish Free Schools and US Charter Schools are operated by for profit companies, which is widely attributed to their success. There is also, more specifically, some US and Swedish evidence to suggest that the profit element is particularly relevant to raising standards in poorer neighbourhoods.[64]

UK public opinion has tended to be cautious about profit-making companies delivering schooling, although research by the Parthenon Group found 60% of parents would be willing to consider sending their children to such a school.[65] More generally, a poll commissioned by Reform in May 2011 found that 52% felt that companies doing a better job of running public services than the government deserved to make a profit.

Given the understandable sensitivity of introducing the profit motive into schooling, it would be sensible to proceed carefully. There are strong practical reasons for wishing to encourage businesses – including chains – to help provide the additional places and choice that parents wish to see, as well as contributing expertise that can help introduce higher standards of teaching in the state sector.

Therefore, in order to promote the expansion of the academy and free school program, it is proposed that the bar on profit-making companies be lifted, subject to three safeguards.

- First, a requirement that a minimum of 50% of any profit be returned as investment into the school.

60 *'The Academies Programme'*, Comptroller General, National Audit Office, 2010.

61 For a review of almost 400 free schools in Sweden, see Böhlmark and Lindahl, *Independent Schools and long-run educational outcomes,* 2012.

62 *'Attainment at Key Stage 4 by pupils in Academies 2011'*, Department for Education, 2012.

63 For a more detailed consideration of the value of chains, see James O'Shaughnessy, *Competition Meets Collaboration*, Policy Exchange, 2012.

64 See S.F. Wilson, *Learning on the Job*, Harvard, 2006; and Gabriel Sahlgren *Schooling for Money*, Institute of Economic Affairs, 2010.

65 Parthenon Group, *Academies: What does the Future hold?,* 2010.

- Second, a requirement that dividends only be paid if a set of educational performance standards are met.
- Third, a bar on the sale for commercial gain – as opposed to reinvestment – of school assets purchased with taxpayers' money.

7. HEALTH SERVICES

Level the playing field

For all the heated political furore that surrounds the subject, there has been a gradual increase in private sector involvement in the NHS over the last 12 years. In November 2000, Labour Health Secretary, Alan Milburn, signed a 'concordat' with the private sector that allowed NHS patients to be treated on private sector premises, by NHS or private staff.[66]

In 2002, the Department of Health stated that:[67]

> *"The NHS cannot remain a monolithic, centrally run provider' and that 'Working with providers from the independent sector and from overseas is not a temporary measure. They will become a permanent feature of the new NHS landscape and will provide NHS services."*

After 2002, the NHS began to make more structured and formal use of private sector capacity with the introduction of the Independent Sector Treatment Centre (ISTC) programme. This involved the Department of Health commissioning private companies to build and operate treatment centres to deal with patients requiring less complex procedures including general surgery and orthopaedic treatment. Twenty-nine ISTCs were built at a cost of £1.7 billion. A second phase of ISTCs was announced in March 2005, with projected spend of £3.75 billion.

Competition was also introduced within the NHS itself. Activity-based funding of NHS hospital services in England was introduced progressively from 2003/04 under the title 'Payment by Results' (PbR). Further reforms under Labour prioritised patient choice. Since January 2006, patients requiring a referral to a specialist have been entitled to a choice of four or five providers. Since April 2008, NHS patients resident in England have been entitled to choose for routine elective procedures among all providers (public or private) willing to supply to NHS quality standards at the PbR price. In 2009, the NHS Constitution made this a right for NHS patients in England. The policy was initially named 'any willing provider' (AWP), but has since been rebranded as 'any qualified provider' (AQP) to highlight the requirement that certain service standards must be met.[68]

Polling suggests private providers are highly rated by patients. A survey by the Care Quality Commission in 2009 found 96% of NHS patients using independent facilities for elective surgery consistently rate the care they receive as 'excellent' or 'very good'. The comparative figure for NHS facilities is 79%. Feedback on the NHS Choices website (based on 150,000 responses) shows that nine of the top 20 highest rated NHS hospitals recommended by patients are run by the independent sector. There are no independent sector hospitals in the bottom 20.[69]

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66 British Medical Journal (BMJ), *Alan Milburn signs concordat with the private sector*, 4 November 2000.

67 Department of Health, *Growing capacity: a new role for external healthcare providers in England*, 2002.

68 Office for Health Economics, *Competition in the NHS,* 2012.

69 NHS Partners Network, *A positive partnership: the independent sector and the NHS,* 2011.

To date, the impact of private healthcare providers is concentrated in elective surgery. In 2010/11, ISTCs accounted for 6% of gallbladder removals, 17% of hip replacements and 17% of hernia repairs funded by the NHS.[70] Table 4 shows the number of private sector admissions as a proportion of total elective admissions over the period since 2003/04.

When a service is opened up to AQP, patients can choose from a range of providers all of whom meet NHS standards and price. The Coalition is committed to extending patient choice of AQP starting with selected community and mental health services.[71]

The Health and Social Care Act 2012 makes further changes to how care is commissioned in the UK. Health and wellbeing boards will bring together local commissioners of health and social care, elected representatives and representatives of Healthwatch to agree an integrated way to improving local health and well-being. Most NHS care will be commissioned by clinical commissioning groups, which will give GPs and other medical clinicians responsibility for allocating resources to secure high-quality services.

NHS providers will no longer be performance managed by Strategic Health Authorities. There will be a consistent system of regulation for all providers. The Care Quality Commission will ensure services meet safety and quality requirements, while Monitor will promote efficiency, with powers to set prices, ensure competition works in patients' interests, and support service continuity.[72]

70 Institute for Fiscal Studies/Nuffield Trust, *'Choosing the place of care: the effect of patient choice on treatment in England, 2003-2011'*, November 2012.

71 House of Commons Library briefing note, December 2012.

72 Details from Department of Health briefing note, April 2012.

The 2012 Act allows the Department of Health to set regulations giving Monitor, as the new economic regulator for the NHS, the power to investigate and remedy anti-competitive behaviour by clinical commissioning groups or the NHS Commissioning Board.

Labour introduced substantial competition into the NHS, along with rising private sector delivery of services. The Coalition has cautiously, and only incrementally, sought to extend it. Nevertheless, there have been striking examples of success, such as the recent turnaround by Circle of Hinchingbrooke hospital in Huntingdon. Circle took over the hospital in £40million of debt, and through effective management and private sector discipline, cut waste, reduced waiting lists, raised standards of quality in care and even found resources to cap parking charges. The hospital's Accident and Emergency department went from being the regional basket case to the best in the country.[73]

Furthermore, there is substantial public support for greater choice in the NHS. A survey of 5,000 people in 2011 found that three quarters wanted more choice over by whom, how and where they are treated.[74] According to ComRes, 75% also agree that a variety of different providers of public services – including charities and companies – would be more successful than one.[75]

The 2012 Act already limits competition in the NHS to quality rather than price of services. Even then, there are significant barriers to entry for non-NHS providers. An Office of Health Economics review in 2009 estimated that private sector providers face the

73 Reported widely, including *Hunts Post*, 24 January 2013.

74 Press release, Department of Health, 11 October 2011.

75 ComRes, July 2012.

equivalent of 12% to 15% extra costs in competing with public sector providers, because of VAT, corporation tax, pension liabilities and capital investment costs.[76]

The Government's impact assessment to the 2012 Act acknowledges that these distorting and 'arbitrary' discrepancies prejudice non-NHS providers, stating: 'The existence of fair playing field distortions results in inefficiency'.[77] A further report by Monitor documented a cultural bias in tendering of services, inaccuracies in the PbR system and tax asymmetries which strengthen barriers to entry, thereby circumscribing patient choice.[78] On top of that, political controversy led to increased regulatory restrictions in the 2012 Act, while Monitor has placed significant additional financial constraints on non-NHS providers.

At the very least, we need a more level playing field, in order to expand patient choice. This could be achieved by either paying a 'premium' or granting a tax break to private providers in recognition of the uneven playing field for pension liabilities, corporation tax and VAT purposes, along with the standardisation of accounting requirements in the delivery of health services.

[76] J. Sussex, *How Fair? Competition between independent and NHS providers to supply non-emergency hospital care to NHS patients in England*, Office of Health Economics, 2009.

[77] Health and Social Care Bill, *Impact Assessment*, 2011.

[78] Monitor, *Fair Playing Field Review – for the benefit of patients*, 8 November 2012.

TABLE 4: PRIVATE SECTOR ACTIVITY IN THE NHS 2003/04 TO 2011/12

Year	Private sector "Finished Consultant Episodes" (FCEs)	Total elective admissions within the NHS	Private sector activity as proportion of elective activity within the NHS (%)
2003/04	3,633	5,544,864	0.07%
2004/05	36,599	5,530,359	0.66%
2005/06	53,388	5,821,062	0.92%
2006/07	67,210	5,590,579	1.20%
2007/08	105,604	5,900,000	1.79%
2008/09	205,954	7,047,293	2.92%
2009/10	251,084	7,257,937	3.46%
2010/11	319,597	7,441,511	4.29%
2011/12	357,008	7,633,641	4.68%

Source: Hospital Episode Statistics, compiled by the House of Commons Library.

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