

# Competition, Regulation and Price Controls in the GB Retail Energy Market

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From 1997 to 1999, the Great Britain (GB) domestic (residential) energy market was opened up to retail competition. Soon, Ofgem deemed the market sufficiently competitive to remove the final transitional price caps. Competition continued to develop. Many other countries followed suit. In early 2008 Ofgem declared “the market is sound”.

Later in 2008, Ofgem expressed concern about competition and ‘unfair price differentials’. It introduced the first in a series of regulatory interventions. Eventually Ofgem referred the market to the Competition and Markets Authority (CMA). The CMA confirmed a competition problem, quantified the customer detriment at an average of £1.4bn per year over 2012-2015, and prescribed new remedies, including a price cap on prepayment meter tariffs. In June 2017 most political parties fought the election on manifestos that proposed to intervene more extensively. In 2018 the Government introduced a Bill requiring Ofgem to impose a price cap on Standard Variable Tariffs, applying to about 70 per cent of all domestic customers. It has all-party support and the price cap is expected to be in place before the end of 2018.

So, there have been two dramatically different decades of regulatory policy on retail energy markets. The first and main part of this paper provides an account of the second decade, explaining how regulatory policy gradually evolved to where it is today.

The prevailing view – shared by the Government, the Parliamentary Select Committee that vetted the Bill, the CMA, Ofgem, consumer organisations and most of the media – is that there is now a serious competition problem in this market. In the CMA’s terms, ‘weak customer response’ has given the major suppliers market power, which they have used to set excessive prices and to discriminate against less engaged customers. For many who hold this view, the problem merits a serious remedy like extensive price control.

The second part of this paper presents an alternative view, supported by several former energy regulators and some regulatory economists, that challenges the Ofgem and CMA analyses. It questions whether weak customer response has given the major suppliers market power, and whether prices and profits have been excessive. It explains that price discrimination or differentiation can be a reflection of competition rather than market power. There may be a social or political concern about price differentials, especially involving vulnerable customers, but there is not a competition problem in the generally accepted sense of the term. Hence widespread price controls are not called for, and are likely to make things worse.

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## **1. Developing the Competitive Retail Market 1998-2008**

In Great Britain, retail markets for electricity and natural gas were opened up to competition in several phases over the period 1990 to 1999, starting with the largest industrial customers and proceeding to the smaller commercial and domestic customers. The thinking was that retail competition would be more effective than a regulated monopoly in passing on to customers the benefits of competition in generation and wholesale markets. Competition would also provide greater stimulus to efficient purchasing and operations, and to innovative tariffs.

Initially, transitional price caps were put in place in the domestic market. But competition developed quickly. By 2002, the 14 incumbent electricity suppliers had consolidated into five energy suppliers, but now largely separate from their previous distribution network businesses. They had taken nearly 40 per cent of the gas market where the former incumbent British Gas had previously held a monopoly. For its part, British Gas, rebranded as Centrica, was now separated from its transmission and network businesses, and had become the largest electricity supplier, supplying 22 per cent of the domestic electricity market. Supplying both fuels (dual fuel) soon became a common means of competition. There were a few new entrants, but at that time they never took more than 1 per cent of the market in aggregate from the so-called Big 6 suppliers.

In 2002 Ofgem abolished the price caps because, as Ofgem's Chairman and Chief Executive explained, 'The evidence is overwhelming that competition is effective across all social groups and all methods of payment' (BBC News, 15 February 2002). Competition could deliver more benefits for customers than regulation, and 'ongoing price controls posed serious risks of braking or throwing into reverse the development of competition. These risks were judged to be the more serious if regulation were to be more tightly focused on prices paid by particular customer groups' (Ofgem 2003, para 3.6).

At the same time, Ofgem announced a substantial programme of work to remove continuing obstacles to competition (associated with the transfer process, misselling, objections to switches etc). It sought to improve customer information and billing standards. And it extended its Social Action Plan to 'ensure that the benefits of competition are extended to all customers, including Prepayment Meter (PPM) customers, vulnerable customers, and the fuel poor' (Ofgem 2003 para 8.28). At that time, the suppliers voluntarily offered various 'social tariffs'.

Ofgem also issued reports on the retail market. For example, Ofgem (2007) reported vigorous price competition for all customers; innovation by suppliers in terms of fixed and capped price deals, cheaper online deals and green tariffs; improving customer service; and customer switching rates at their highest in four years. On 16 January 2008, responding to Government and public concerns about recent energy price increases, Ofgem issued a press release headed "Market is sound – Ofgem assures Chancellor".

## **2. Ofgem's Probe and the non-discrimination condition 2008**

One month later, on 21 February 2008, Ofgem launched a 'probe into energy supply markets', 'to address mounting concern among customers that could undermine competition'. Its *Probe Initial Findings* (Ofgem 2008) did not find excessive profits: it said 'assessment of suppliers' profitability is difficult' (p. 114). Nor did it find a reduction in competition: on the contrary, 'there are now greater levels of competitive activity and consumer switching than in almost

every other energy market in the world and most other UK consumer services markets. The fundamental structures of a competitive market are in place, and the transition to effective competitive markets is well advanced and continuing' (p. 5).

However, the report 'found some important areas where the transition to competitive markets now needs to be accelerated'. (p 1) Relatively few customers were 'proactively and confidently engaged in the energy market' (p. 59). Their switching was not protecting the less active customer groups, including vulnerable customers, who were paying about £1 billion per year more than those on lower tariffs.

To remedy the situation, Ofgem proposed a package of 20 new measures. These included actions to promote more active customer engagement (including by clearer information on customer bills, an annual statement to each customer, an annual prompt about switching, a programme to promote confidence in price comparison and switching sites, and a customer awareness programme) and to help consumers make well-informed choices (including by an easy-to-understand price metric and rules on suppliers' sales and marketing activities). There were also actions to reduce barriers to entry and expansion (for example, via suppliers publishing segmental accounts and by improving market liquidity).

Ofgem's particular concern was 'unfair price differentials'. Its main example was that 'the five former incumbent electricity suppliers charged electricity customers in their former monopoly areas an average of over 10 per cent higher prices than comparable 'out-of-area' customers' (p. 8). Ofgem therefore proposed a non-discrimination condition, to 'ensure that price differentials are objectively justified by cost differences' (p. 15). Ofgem had previously (between 1999 and 2002) twice considered such a condition, but had rejected it on the grounds that it could reduce the incentive to compete for out-of-area customers and provide an incentive to raise out-of-area prices rather than reduce in-area prices.

Ofgem then quantified the amounts at issue.

8.76. Net of £650 million of costs, we have identified that suppliers benefit in total by around £1 billion per annum from premiums charged to certain groups of customers. ....

8.77. Although our calculations are based on current tariffs, and are not directly comparable, it is notable that the annual premium we have identified exceeds the average annual net margin earned by the Big 6 retail energy businesses between 2005 and 2007. As a result, if these differentials were eroded, it may be through a re-balancing between prices rather than by a straightforward decrease in price for the most impacted customers.

8.78. If we assume the average prices paid by the consumers remains unchanged, the annual cost of energy to a DF-DD [dual fuel direct debit] customer would have to rise by around £40 per customer, or 3.5 per cent on the average dual fuel bill, to rebalance the differentials. If we used this higher level as the new benchmark for assessing the scale of differentials, the impact would fall from £1 billion to around £550 million.

8.79. Although a rebalancing of this type would not reduce average prices paid by consumers it would disproportionately benefit vulnerable groups. It would also improve the prospects for new entrants and small suppliers because margins for the most price sensitive and active segments would improve to levels that may make market entry profitable' (Ofgem 2008, pp. 113-4).

The subsequent press release (Ofgem R35 16 December 2008) was not quite so balanced: it was headlined 'Ofgem probe has half a billion pounds in its sights for customers'. It made no mention of the average bill rising by £40 per customer.

### **3. Results of the non-discrimination condition**

A number of economists were critical of the proposed non-discrimination condition. Professor Catherine Waddams (2009) said it was ‘likely to stifle competition’. Professor George Yarrow resigned from Ofgem’s governing board GEMA on the issue, later referring to the ‘professional consensus’ that the proposals would have ‘harmful consequences for consumers and for competition’ (Yarrow 2009). The former Director General of Fair Trading referred to this ‘bad policy’ that ‘stops important kinds of price competition’ (Vickers 2009).

Ofgem implemented the condition in September 2009 for a period of three years, promising ‘a thorough review of the impact’ before the condition terminated. In February 2012 Ofgem proposed to renew the condition for two years. In the event it allowed the condition to lapse, without a review of the impact but with a strong warning to suppliers not to resume differential pricing.

The average customer switching rate – the proportion of customers changing supplier in any year, also called ‘churn’ - had steadily increased from about 15 per cent in 2003 to 20 per cent in 2008. Then it fell steadily to about 16 per cent in 2011. This fall seems mainly attributable to two factors, the first of which was the non-discrimination condition, which reduced the price differentials that motivate switching.

The second factor was that, as part of its Probe remedies, Ofgem introduced stricter conditions on sales and marketing, which came into force in October 2009 and January 2010. These proved so onerous that in July 2011 one of the major suppliers abandoned doorstep selling completely, and within another year all had done so. This meant that suppliers had less ability to engage with customers in lower socio-economic groups. The average switching rate continued to fall, now even more sharply, to just over 10 per cent in 2013.

#### **4. Further regulatory interventions: simpler tariffs**

In June 2010, a year after introducing its non-discrimination condition, Ofgem (2010a) noted a 38 per cent increase in net retail profit margins. In November, following a further increase in margins, Ofgem (2010b) announced an intention to review again the effectiveness of competition in the retail energy market. The resulting Retail Market Review (RMR) found that the ‘unfair price differentials’ had reduced but little else had changed. Indeed, there was a deterioration in the market insofar as customers were now less active. Ofgem (2011a) attributed the fall in switching to ‘complex pricing structures’ and ‘an increase in the number of tariffs available’. The CMA (2016 para 8.66) indicates that these latter developments were in part a consequence of Ofgem’s non-discrimination condition, insofar as the suppliers now needed to compete in other ways and the condition provided for various exemptions to do so.

Ofgem (2011b) announced the implementation of various measures foreshadowed in the *Probe Initial Findings*. Suppliers were required to provide a price comparison guide and a Tariff Information Label. There were proposals to improve bills, annual statements, contract renewal statements and price increase notifications. These measures were remarkably prescriptive, extending for example to the specification of wording and font sizes on customer bills. The changes expanded the standard supply licence from 68 pages in 2007 to several hundred pages.

But the central proposal now was tariff simplification. Ofgem concluded that ‘further radical actions are required’, the most significant of which was ‘to make it far easier for domestic consumers to compare prices and get a better deal’. The focus was on standard evergreen tariffs (now generally known as Standard Variable Tariffs or SVTs) which typically have a fixed (or

customer or standing) charge per month or per quarter, plus a unit charge per kWh consumed. With due notice (one month), such tariffs can be changed (i.e. are variable) at the supplier's discretion. If wholesale prices were stable they might not be changed for a year or two, but might be changed twice in a year if wholesale prices were moving significantly and unpredictably.

Ofgem now proposed to restrict and standardise these tariffs.

3.15 We intend to address confusion in the domestic market by a proposal to restrict the number of tariffs for standard evergreen products from each supplier to only one per payment method. We also propose to standardise the format of these tariffs across suppliers, with suppliers allowed to compete on a single 'per unit' price. Consumers would then be able to tell at a glance whether they can save money either by switching supplier or by moving to a new deal. This would be a major reform impacting the 75 per cent of customers currently on standard evergreen products. (Ofgem 2011a p. 48)

This standardised format would be achieved by Ofgem itself setting a uniform fixed charge for all standard tariffs. Suppliers would then compete on a single unit rate for each standard tariff. In addition, discounts and bundled products and services would be prohibited.

This degree of standardisation seemed extreme: I called it Ofgem's Procrustean Bed (Littlechild 2012a). Others evidently felt similarly. After 19 months of consultation and deliberation, Ofgem (2012) abandoned this proposal, citing unspecified 'concerns' and 'practical difficulties'.

Ofgem now proposed instead that each supplier should be limited to a maximum of four tariffs per fuel (natural gas and electric power) per payment method (direct debit, standard credit and prepayment). All tariffs were to have a simple two-part structure, that is, a standing charge and a single unit rate. The standing charge could be zero, but the unit rate could no longer vary with the level of consumption, so declining block tariffs were prohibited. Discounts were allowed only if expressed in pounds, not as percentages, and were later prohibited other than for dual fuel and online accounts. Customers on 'dead tariffs' – those no longer available to prospective new customers – were required to be moved to that supplier's cheapest 'live or open tariff'.

Some obvious concerns were expressed (Littlechild 2012b, 2014). It would mean the removal of tariff varieties that customers valued. In practice it would not make the choice situation much simpler: the ever-growing number of suppliers meant over 100 tariffs to compare (and with three payment methods and 14 regions that meant many thousands of tariffs nationally). And it was not at all clear that simplicity of tariffs was the main driver of customer engagement.

Another consequence was a burgeoning of proposals for other interventions. Some favoured requiring each supplier to put all its customers on its 'best' tariff. Prime Minister David Cameron surprised everyone at Parliamentary Question Time by saying that the Government proposed to require suppliers to put their customers on the best tariff in the market. Two obvious problems with such suggestions was that they assumed that the 'best' tariff was unambiguous, and more importantly that the tariffs offered in the market would be unaffected by such obligations. If a discount to attract new customers had to be extended to all existing customers, that would likely make it unprofitable to offer such a tariff (as the non-discrimination condition had earlier demonstrated).

A consumer organisation (Which?) advocated a 'petrol pricing' approach whereby each supplier would be restricted to a single nationally uniform price per kWh, with no fixed charge. The former Prime Minister Sir John Major proposed a windfall tax on energy suppliers. The Labour Party leader and former Energy Secretary Ed Miliband proposed to freeze energy tariffs until after the next election. This later became part of Labour's 2015 election manifesto. The

Conservatives responded that ‘healthy competition, not short-term political intervention, is the best way to secure a good deal for consumers’.

With some modifications, Ofgem’s simple tariff rules and other prescriptions finally came into effect by January 2014. Pollitt and Haney (2014) argued that ‘a once showcase example of residential electricity market competition is being undermined by increasingly misguided politically motivated interventions in the way the market operates’.

### **5. Some consequences of the simple tariff rules**

Ofgem’s website said that ‘the new rules strip away unnecessary complexity in tariff choices’. In practice, this meant that introductory discounts, ‘cash-back’ schemes and loyalty discounts were banned. So, too, were discounts for prompt payment. One supplier’s new tariff, that for several months price comparison websites deemed ‘the best offer in the market’, was prohibited because the discount was greater in the first year than in the second. Previously popular tariffs with no fixed charge were largely withdrawn because they typically involved a two-tiered unit rate (a declining block tariff) that was now prohibited.

One supplier had offered a ‘StayWarm’ tariff that gave customers over 60 years of age a fixed monthly bill regardless of how much energy the customer used (though the bill could be adjusted on a forward-looking basis depending on actual usage). Ofgem had highlighted it in 2001 as one of a small number of major initiatives by fuel companies to address the needs of the fuel poor. It was now withdrawn because it could not be adjusted to meet Ofgem’s new conditions.

Predictably, when restricted to four tariffs, suppliers focused on the most popular, profitable and reliable products. Minority tariffs such as green tariffs were largely withdrawn. Innovation suffered, partly because certain tariff types (for example, with wholesale price tracker mechanisms) were prohibited, and also because introducing a new tariff for which demand was uncertain required withdrawing one of the four tried and tested tariffs.

Ofgem’s rules required that suppliers alert customers to their best available variable tariff. And at the end of a fixed-period tariff, in the absence of active customer choice otherwise, suppliers had to transfer customers to their best available variable tariff. Suppliers therefore found it uneconomic to use variable tariffs as low price ‘acquisition tariffs’ for gaining new customers. Instead, the main suppliers each limited themselves to one standard variable tariff and to two or three fixed-price fixed-period tariffs, typically for 12, 18 and 24 months. The latter tariffs provided suppliers with flexibility over time but militated against longer term customer relationships.

### **6. The CMA investigation**

In July 2013 the Energy and Climate Change Committee (2013) was very critical of rising energy prices, of the six large energy companies, and of Ofgem’s lack of action. In November 2013 a new chairman was appointed at GEMA (the Gas and Electricity Markets Authority, the parent body of Ofgem). The Secretary of State then announced that Ofgem would work with the Office of Fair Trading (OFT) and the new Competition and Markets Authority (CMA) - this organisation was in process of being formed from the merger of the OFT and the Competition Commission (CC) - ‘in preparing a framework for the assessment of competition in energy markets and would then conduct that assessment’. The Secretary of State’s direction of the referral process was unusual, as was the concept of a sector regulator and the competition authority working jointly to prepare a framework for the assessment of competition. It has

recently been said that the Prime Minister asked Ofgem and the OFT to assess the market. (Parliament 2018, para 6)

In March 2014 this joint *State of the Market Assessment* (Ofgem et al 2014) identified a number of features of the market that might have an adverse effect on competition. In June, Ofgem (2014) referred the sector for a market investigation by the CMA, identifying essentially the same five issues for examination, namely weak customer response, incumbency advantages, possible tacit coordination, vertical integration and barriers to entry and expansion.

The terms of reference focused on supply to domestic and micro-business customers. They allowed the CMA to investigate related features (such as industry code requirements, third party intermediaries, the regulatory framework, and ancillary goods and services such as bundling boiler services with energy supply). But they excluded supply to larger customers ‘because we have little evidence of harmful features on those markets’ (p. 14).

The CMA reported in June 2016. Contrary to many expectations, it found that four of the five identified issues – incumbency, tacit coordination, vertical integration, and barriers to entry and expansion – were not a problem. Nor were other important and sometimes controversial aspects of the UK energy market, such as the wholesale electricity and gas markets and the self-dispatch system in electricity. These findings were perhaps surprising – reportedly they surprised the CMA panel itself – but they have not since been challenged.

The CMA identified ten features of the market that did give rise to an Adverse Effect on Competition (AEC). Six of these were the following: the absence of locational prices for transmission losses and constraints, the Government’s mechanisms for allocating Contracts for Differences (CfDs) related to renewables without using a competitive process, the inefficient allocation of costs in gas settlement, the absence of a firm plan for moving to half-hourly settlement in the domestic electricity market, aspects of industry code governance that limited innovation and pro-competitive change, and ‘an overarching feature of a lack of robustness and transparency in regulatory decision-making’. (This latter finding related to the downrating of the competition duty in Ofgem’s statutory objectives, the absence of a mechanism for transparently addressing disagreements between Government and Ofgem, the lack of effective communication on the impact of government and regulatory policies on energy bills, and the lack of a regulatory requirement for clear reporting on generation and retail profitability.) The CMA specified various remedies for these AECs.

A seventh AEC was Ofgem’s simple tariffs requirement following its Retail Market Review. The CMA (2016, paras 171-175) explained at length why this had an Adverse Effect on Competition.

There are few, if any, signs that customer engagement is improving materially, either in terms of direct customer activity (eg switching, shopping around) or their experience and perception (eg views on tariff complexity). ... [Suppliers withdrew] a number of tariffs and discounts and changing tariff structures, which may have made some customers worse off. ... The RMR four-tariff rule limits the ability of suppliers to compete and innovate and provide products which may be beneficial to customers and competition. ... [The RMR rules] dampen price competition by limiting the ability and incentives of suppliers to respond to competition by offering cheaper tariffs or discounts (which means that they, in turn, put less competitive pressure on their rivals

The CMA recommended that Ofgem remove its simple tariffs restrictions.

The remaining three Adverse Effects on Competition were associated with ‘weak customer response which, in turn, gives suppliers a position of unilateral market power concerning their

inactive customer base which they are able to exploit through their pricing policies or otherwise'. The CMA found this weak customer response in both the domestic market and in the micro-business market. The CMA also found that technical constraints, higher costs and other issues had accentuated the problem of weak customer response in the prepayment sector of the domestic market.

As remedies, the CMA proposed various ways of increasing customer engagement to combat the weak customer response. In the prepayment sector these remedies were to be accompanied by a temporary price cap on prepayment meter tariffs until smart metering removed the technical constraints. The CMA required suppliers to microbusinesses to make clearer their contract prices and termination arrangements.

Discussion of the CMA report mainly focused on its analysis of weak customer response in the domestic market and associated customer detriment, and its proposed remedies. These are now set out in more detail.

## **7. Weak customer response, customer detriment and remedies**

In assessing the nature of competition in the domestic energy market, the CMA noted the rapid expansion in the market shares of smaller suppliers: from less than 1% in 2011 to 13% in Q1 2016. (Ofgem's data portal shows that, as of September 2017, there were over 60 such suppliers with a total market share of 20 per cent.) Presumably the recovery of positive profit margins after 2008, and the pause in and/or reversal of wholesale price increases, made new entry via fixed price products more attractive. In addition, entrants had the benefit of exemption from significant environmental and social policy costs until they acquired 250,000 customers. Either way, new entry was a reality, this put the Big 6 suppliers (whom the CMA called the Six Large Energy Firms or SLEFs) under increasing pressure, and (in aggregate) they were steadily losing market share.

However, the CMA was more concerned about limited customer engagement. Its survey of domestic customers suggested to it that substantial numbers of customers were disengaged from retail energy markets. For a dual fuel energy customer of the Six Large Energy Suppliers, the saving from changing to the best tariff (under the most liberal scenario, potentially changing supplier, tariff and payment method) averaged £164 per year over the period Q1 2012- Q2 2015. The saving increased during this period to the equivalent of £330 in Q2 2015 (CMA 2016, pp. 31-32). Furthermore, the scope for saving was not randomly distributed across the customer population.

135. ... The survey results also suggest that those who have low incomes, have low qualifications, are living in rented accommodation or who are above 65 are less likely to be engaged in the domestic retail energy markets. (p. 33)

The CMA deduced that limited customer engagement was not because saving money was unimportant, but because of other factors: the lack of quality differentiation of gas and electricity supply, the lack of visibility of conventional meters, actual and perceived barriers to accessing and assessing information, and for some customers problematic experiences in searching for and switching suppliers. The CMA concluded as follows.

160. Overall, our view is that the overarching feature of weak customer response gives suppliers a position of unilateral market power concerning their inactive customer base and that suppliers have the ability to exploit such a position through their pricing policies: through price discrimination by pricing their standard variable tariffs materially above a level that can be justified by cost differences



from their non-standard tariffs; and/or by pricing above a level that is justified by the costs incurred in operating an efficient domestic retail supply business. (p. 39)

The CMA adopted two approaches to quantify the customer detriment associated with this lack of engagement. Using its ‘direct approach’, the CMA calculated that the average customer detriment averaged £1.4 billion per year over 2012-2015, and reached almost £2 billion in 2015. Using its ‘indirect approach’ the CMA calculated that the detriment averaged £720m per year over the longer period 2007-2014.

To remedy this detriment, the CMA recommended that Ofgem should experiment with different ways of promoting greater customer engagement. It should also establish a Disengaged Customer Database: the six large suppliers would have to give Ofgem the contact details of those of their customers that had been on standard variable tariffs for more than three years, and Ofgem would then make these details available to other interested suppliers. Price Comparison Websites should also be enabled to compete more effectively by relaxing the obligation on them to list all tariffs. Henceforth, a particular site, in association with a particular supplier, would be able to offer a tariff that was not listed on other sites.

In its Provisional Conclusions, the CMA had considered a wide range of remedies. In the light of extensive consultation responses it explicitly rejected the possibility of extending a price cap to all standard variable tariffs. (This would have extended the coverage of the price cap from nearly one sixth to about two thirds of GB domestic customers.) In its Final Report, the CMA majority explained this view:

... attempting to control outcomes for the substantial majority of customers would – even during a transitional period – undermine the competitive process, potentially resulting in worse outcomes for customers in the long run. This risk might occur through a combination of reducing the incentives of customers to engage, reducing the incentives of suppliers to compete, and an increase in regulatory risk. (p. 656)

In a dissenting view on this particular issue, one CMA member (Professor Martin Cave) argued that the proposed remedies did not go far enough.

The harm which is presently inflicted on households in this market (£2 billion in 2015, or an average of £75 for every British household) is very severe, and in my opinion how far and how fast that harm is reduced is the key indicator of the success of the household market remedies. But the remedies proposed for the large majority of households will take some time to come into effect, and are in any case untried and untested. (p. 1415)

Cave said that, over the previous three years, a wide variety of information remedies and other pressures had been tried and ‘had not made a dent’ in the proportion of customers on standard variable tariffs. Cave therefore proposed to supplement the engagement remedies with a price cap on standard variable tariffs for a temporary period, say two years, to remove a significant part of the 2015 detriment of £2 billion. The body of the report said that this would ‘reset the market’. (p 79)

## **8. Political developments**

Ofgem began to implement those 26 of the CMA’s 30 remedies that fell to it. It withdrew its simple tariff restrictions, and set up several controlled experiments to assess customer response to different approaches, including a database remedy for disengaged customers.

The CMA itself imposed the price cap on prepayment meter tariffs, covering about 4 million customers as from April 2017. At a Select Committee hearing on 10 January 2017, the Secretary

of State commented that £1.4 billion annual detriment to customers ‘is clearly a huge amount of money’. He wondered ‘whether the pro-switching recommendations, which may be important, are sufficient to deal with the detriment that is being suffered by those people who don’t switch’.

In February and March, all but one of the six large suppliers announced price increases. (The sixth announced an increase later.) Conservative MP John Penrose led a cross-party group of MPs arguing for stronger action than the CMA remedies. They secured a debate in the House of Commons on 16 March. The Motion indicates their strong feelings:

That this House deplores the big six energy firms’ treatment of out-of-contract energy customers on default tariffs; believes immediate action is needed to protect those consumers, and that pushing customers to start switching will not fix the problem sufficiently quickly or completely on its own; and calls on the industry, regulators and the Government to consider solutions which recognise that many people lead busy lives and that switching their energy supplier may not always be a high priority.

In April 2017 Prime Minister Theresa May declared a general election, indicating an intention to deal with ‘rip-off energy tariffs’. She would be ‘introducing a cap on unfair energy price rises. It will protect around 17 million families on standard variable tariffs’ and ‘save families on poor value tariffs as much as £100’ (*The Sun*, 9 May 2017). The Conservative Party manifesto promised ‘a safeguard tariff cap that will extend the price protection currently in place for some vulnerable customers to more customers on the poorest value tariffs’.

The Labour Party manifesto noted that the CMA had ‘found customers are overcharged an enormous £2 billion every year’. It proposed an immediate energy price cap to keep average dual fuel bills below £1000 per year, and an intention to take energy back into public ownership in stages. The Scottish National Party supported an energy price cap on standard variable tariffs. The Green Party supported public ownership. UKIP proposed to review ownership and profits of British utilities. In total, parties proposed over a dozen additional measures related to energy costs, efficiency, competition and protecting customers.

In June 2017, after the election, the Secretary of State asked Ofgem to advise him on what action Ofgem intended to take with respect to ‘safeguarding customers on the poorest value tariffs’ and ‘the future of standard variable tariffs’. Ofgem replied (3 July 2017) that it would examine ‘measures to protect and empower vulnerable customers’ and ‘look at options including extending the current safeguard tariff’. Subsequently, in December 2017, Ofgem extended the PPM price cap to an additional 1 million consumers who qualified for the Warm Home Discount, and indicated that it was exploring ways to extend the cap to an additional 2 million vulnerable consumers.

John Penrose complained that ‘some 17 million families are being ripped off by expensive standard variable tariff deals. Ofgem’s proposals will deal with at most 3 million of them, leaving 14 million still be preyed on by the big six energy firms’ (Hansard, Vol 626, col 891, 3 July 2017). Supported by numerous small suppliers, Penrose also argued for a relative rather than an absolute price cap.

[An absolute price cap] ‘is a highly distorting approach which replaces daily market-derived prices with infrequent regulator-derived ones. The capped prices will not only be out of date as soon as wholesale gas prices change (which happens every day) but will also throttle competition by being far less good at discovering and then meeting consumer needs.

A relative cap fixes a maximum mark-up between each supplier’s best competitive price and their default tariff. That means it protects customers who don’t switch from being ripped off, but still leaves a

worthwhile incentive for those that do. It won't get out of date as wholesale gas prices change, because it is based on the only genuinely market-driven prices in the retail energy sector – the fixed-term switching deals where more than 50 firms vie for customers every day – and competition is kept red-hot by price-comparison sites that continuously advertise the best deals.

Because of these competitive foundations, a relative cap creates a more effective long-term guarantee of low prices and good deals for customers than any price decision by a regulator, however clever and well-intentioned they may be. By forging a link between the highly-competitive part of the energy market, and the currently uncompetitive (and therefore rip-off) default tariffs, a relative cap imports strong competition from fixed term switching deals, and applies it to default tariffs too. (<http://johnpenrose.org/wp/energy-price-cap-update/>)

The Secretary of State suggested that Ofgem's 'initial proposal' was 'a step in the right direction' but, if it did not sufficiently eradicate the consumer detriment identified by the CMA, he remained prepared to legislate. However, he maintained that it would be quicker for Ofgem to take action. Ofgem's CEO countered that 'this kind of intervention—an intervention that will, frankly, have significant distributional effects—is really a matter for Parliament'. (House of Commons 2017, Q74)

Meanwhile, on 6 August the Government commissioned Professor Dieter Helm to undertake an independent review of the cost of energy. In an earlier critique of the CMA analysis he had proposed a solution to the retail issue. (Helm 2015, 2017a) Suppliers would be required to offer (in addition to whatever other tariffs they offered) a default tariff, equal to indexed wholesale price + fixed cost pass throughs + an unregulated published margin for billing, metering and customer services. To compare these default tariffs, customers would simply look at the only element that varied between suppliers, namely the published margin. The size of these margins would not be regulated but they would be published on the Ofgem comparison website that the CMA at one time considered.

The CMA rejected Helm's proposal on the basis that, if awareness of these margins remained low and/or customers did not act on this awareness, which the CMA considered reasonably likely, then this remedy would not provide protection to customers. (Helm 2015, para 59) In his *Cost of Energy Review*, Helm again proposed this solution. He also suggested that the Government's proposed SVT price cap could be based on the same concept. 'In implementing the new legislation, Ofgem should therefore focus its price cap proposals on a maximum margin within the default tariff I recommend, leaving headroom for competitors to offer lower margins, or indeed any other tariffs that they may seek to offer to customers.' (Helm 2017b p 164)

## **9. The Tariff Cap Bill**

In October 2017 the Secretary of State finally published a draft Bill requiring Ofgem to impose a price cap on standard variable tariffs. The BEIS Select Committee was asked to give the draft Bill a pre-legislative scrutiny. It reported in February 2018, in favour of taking such action.

Sadly, competition in the domestic energy market is not working effectively for 12 million customers stuck on poor-value tariffs called standard variable and default tariffs. This market has become two-tiered, with some consumers paying up to £300 more than others each year. ... Where markets fail to deliver fair outcomes, intervention is justified.

... Those retailers who were found by the Competition and Markets Authority to be operating inefficiently and passing excess costs onto standard variable and default tariff customers have brought this intervention upon themselves. We hope they start treating their loyal customers more fairly in the future.

The market has been dysfunctional for years. And yet Ofgem has been too slow and reluctant to use its extensive powers to step in and protect the interests of customers, especially vulnerable customers. ...

These repeated failures have led us to support the Government's initiative to set a temporary absolute price cap on standard variable and default tariffs. We agree with the Government that the evidence is on balance against a relative price cap: it would create a perverse incentive for suppliers to increase their lowest prices to keep their profit levels constant. An absolute cap also bears a risk of increasing prices but this risk is lesser and it will be the most effective measure at delivering the Bill's key goals: improving fairness and reducing the overcharging of standard variable and default tariff customers. We concluded that the Competition and Markets Authority's Energy Market Investigation remedies alone would not necessarily fix the problems in the market soon enough. (House of Commons 2018c, Summary)

On 26 February 2018, the Secretary of State introduced the Domestic Gas and Electricity (Tariff Cap) Bill, again citing the CMA's calculated £1.4bn customer detriment. The Bill required GEMA (the Gas and Electricity Market Authority, parent body of Ofgem) to "impose a cap on all standard variable and default rates", "with a view to protecting existing and future domestic customers", having regard to the following matters

(a) the need to create incentives for holders of supply licences to improve their efficiency; (b) the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts; (c) the need to maintain incentives for domestic customers to switch to different domestic supply contracts; (d) the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.

The Bill required the Authority to review the level of the cap at least once every six months. There was an exemption for tariffs used to support renewable energy. In 2020, and in each of the next two years if the cap remains in place, the Authority must review "whether conditions are in place for effective competition" and recommend whether the cap should be extended for another year. The cap terminates at the end of 2020 unless the Secretary of State considers that conditions for effective competition are not in place, and renews it for a further year. The cap ends at the latest in 2023.

On 6 March the second reading of the Bill revealed almost universal support, with a few Conservative reservations but no outright opposition. Labour proposed a few modifications including a requirement for the cap to be introduced by 30 November 2018 and to reduce annual bills by at least £100, and for the level to be reviewed every three months. It also proposed the introduction of a relative price cap after the expiry of the absolute price cap, so that those customers 'being placed initially on a low tariff, only to find themselves subsequently being hoisted on to a very disadvantageous tariff' would be protected by 'placing a piece of elastic between the best tariff and the highest tariff'. (House of Commons Hansard 2018, Col 272-3)

These modifications were not accepted but support for the Bill remained. The planned timetable is for the Bill to become law by end-June 2018 and for Ofgem then to implement the price cap by end-November 2018.

## **10. The analysis of profitability and price discrimination**

The remainder of this paper explores in more detail how Ofgem, the CMA and recent Government policy have addressed two key elements of any analysis of market power: the existence or otherwise of excess profits, and the extent and meaning of price differentiation or price discrimination.

In assessing market power, it is customary to look at various aspects of structure and conduct, including the number of competitors and ease of entry. But on the simplest analysis, market power is almost synonymous with excess profits. If there are not excess profits it is difficult to argue that there is market power or that it is harmful. Attention is generally focused on how to

measure profitability and what constitutes an excess profit. See for example Fisher and McGowan (1983).

Price discrimination is more ambiguous. Again on the simplest and traditional analysis, competition is characterised by ‘the law of one price’. Price discrimination is a means by which a supplier with market power can extract more profit than it could by charging a uniform price. Yet the recognition of transactions costs has changed this. A substantial and more recent economic literature has explained why price discrimination can indicate competition rather than market power. Differential mark-ups over cost can be optimal or more efficient (Vickers 1998 p. 179, Baldwin and Cave 1999 p. 209). Price discrimination can be a means of competing and of intensifying competition (Corts 1998, Shaffer and Zhang 2000, Cooper et al 2005). In some circumstances, firms have no choice: the pressure of competition can force them to discriminate, simply to survive (Baumol 2006).

Transactions costs also affect the benefits of opening up markets to competition. Brennan (2007) shows that “If consumers prefer not to choose, opening regulated markets can reduce welfare, even for some consumers who do switch, as the incumbent can exploit this preference by raising price above the formerly regulated level.”

Two other developments in economics are also relevant. One is public choice and the theory of economic regulation: regulators take political considerations into account. The other is behavioural economics, with its recognition that customers are not necessarily the economic agents of elementary economic theory.

## **11. Ofgem’s approach to profitability and prices**

Consider first the economic and political situation in 2008. Domestic energy prices in real terms had fallen steadily for two decades, from the early 1980s to the early 2000s, but then roughly doubled in the next four years (House of Commons Library 2014). The consumer body Energywatch (2007) argued that energy markets were failing consumers, that ‘Ofgem has been complacent at best and negligent at worst’, and that the OFT or the CC should step in. The Government expressed concern about mis-selling, vulnerable customers not switching, and charges for prepayment meters. On 16 January 2008, as noted, Ofgem assured the Chancellor that ‘the market is sound’. But on 5 February the Select Committee announced an investigation into Energy Prices, Fuel Poverty and Ofgem. On 21 February Ofgem announced its own investigation. The Select Committee endorsed the concerns expressed to it and recommended that Ofgem take numerous remedial actions, commenting that this ‘will, however, need Ofgem to demonstrate a rather greater sense of urgency than has been made apparent so far’.

The opening paragraph of Ofgem (2008) set the scene accurately, referring to the ‘unprecedented increases in world fuel prices which have flowed through into record increases in wholesale and retail gas and electricity prices. A typical household's energy bills have more than doubled since early 2004 and many households are now struggling to pay their bills.’ (para 1.1) Energy debt levels and disconnection rates were rising, along with ‘the rising cost of food, petrol, mortgages and other essentials’. ‘Vulnerable consumers and those in fuel poverty are particularly affected.’

However, the main text had only a few paragraphs (in the final section of a 210 page document) of rather technical discussion of the link between wholesale and retail prices, plus an econometric Appendix. The document did not drill home the message that the retail energy price increases – and hence the main public concern - reflected cost increases outside the retailers’

control, and were *not* due to a failure of retail energy markets, or to exploitation by the energy suppliers.

On the contrary, Ofgem left a suspicion that the retailers might be guilty. It ducked the question about excess profits, commenting that ‘assessment of supply companies’ aggregate profitability is fraught with difficulties’ (p. 98). After brief and inconclusive discussion of average retail margins it focused on detailed comparisons for different fuels, for in-area versus out-of-area consumers, for proactive, reactive and inactive consumers, and for different payment methods, expressing concern about those types of consumers who paid the relatively high margins.

These were interesting results, relevant to some then-current concerns. But what was missing was the big picture on the overall absolute profitability – or lack of it – of the retail suppliers. The Probe said ‘8.16. Having gathered evidence on the actual and planned level of profitability in GB energy supply markets, we need to judge whether or not this is consistent with an effectively competitive market.’ But it did not do so.

It seems that the estimated total net retail margins on electricity and gas supply combined (excluding generation), over all six large suppliers, amounted to about (minus) £500 million in 2005, £100 million in 2006 and £300 million in 2007. (Ofgem 2008 Figure 8.1 p 100) So over this three year period of increasing prices, this evidence suggests that retail margins were increasing, but on average were slightly negative. Ofgem later revised its estimates downwards, to about (minus) £250 million in 2005, (minus) £170 million in 2006 and zero in 2007, an average loss of about £140 million per year (Ofgem 2010, Fig 2.1 p. 11). That is, Ofgem’s later figures confirm that the six large suppliers had not been operating at an excess profit for these three years, but in aggregate at a loss.

The data were not ideal, and the significant movements in profitability probably reflected also the significant movements in wholesale prices over time. One of Ofgem’s proposed remedies was to require the Big 6 suppliers to publish separate regulatory accounts for their supply and generation businesses, in order to improve transparency. The CMA later observed that ‘Ofgem’s inability to address concerns about the Six Large Energy Firms’ profitability with the information they currently obtain ... was a significant driver of the set of circumstances which ultimately led to those Ofgem policy interventions which ... have led to AECs’. (CMA 2016, para 18.143)

As indicated, Ofgem was under considerable political pressure because of the increased energy prices. It could have maintained its previous view that ‘the market is sound’ because the companies were not making excessive retail profits, but it did not do so. Ofgem now needed to Do Something.

## **12. Ofgem’s analysis of price differentials**

There had been price differentials in the retail market ever since it opened. Specifically, the five former electricity incumbents offered lower prices to new customers outside of their former monopoly areas than they charged their long-standing customers within their areas. They also offered relatively low gas prices to encourage their electricity customers to become dual fuel customers. Meanwhile, British Gas (Centrica) kept relatively high gas prices but offered relatively low electricity prices to encourage its gas customers to become dual fuel customers. The resulting price differentials were seen as evidence that competition was working: competitors were offering lower prices than the historic incumbent suppliers. And as noted

above, early evidence was that competition (customer engagement) was effective across all social groups.

Ofgem's Probe provided a more extensive and innovative analysis of customer engagement, informed (as Ofgem later noted) by evolving thinking in behavioural economics. It found that various categories of customers were less engaged than others, typically the more vulnerable customers, hence the more vulnerable customers tended to pay the higher prices.

In appraising such differential prices, Ofgem (2008) made no reference to the recent literature on price discrimination as a means of competing. It described price differentials that did not have a 'cost justification' as 'unfair'. It regarded such price differentials as an indication that competition was not working effectively, and that suppliers were using market power to exploit less engaged customers. In those areas, it argued, 'the transition to competitive markets now needs to be accelerated' (p. 1).

Yet the retail energy market appears to be a case where price differentials are actually a means of competing. Retail suppliers are driven by competition to reduce prices to the most active customers - to try to keep those customers most prepared to leave, and/or to try to attract replacement customers from other suppliers. These prices are driven down towards marginal cost. So suppliers have to try to recover their overhead costs (as well as operating costs) from their less active customers. But all their tariffs are subject to competition because all customers can switch. Ofgem's data just discussed indicate that, rather than discrimination being a means of exploiting market power to make excess profits, the six large suppliers in aggregate did not manage to recover their retail operating costs plus overhead costs for the three years 2005-2007.

Subsequent empirical evidence seems consistent with price differentials being a form of competition. Green (2012) noted 'a large increase in the level of the average bill at almost exactly the same time that companies started to reduce their cross-region differences'. Hviid and Waddams Price (2012) cited 'the rising levels of both gross and net margins' as evidence that prohibiting discrimination would increase prices. Later, Waddams Price and Zhu (2016) noted a halving in the difference between the incumbent's price and the best non-incumbent price; they commented that this had reduced customer switching. They concluded that 'the constraint on incumbent price increases has weakened', and that 'this is likely to have been at the 'absolute' expense of just those consumers whom the regulator sought to protect.'

This is not to deny that differential prices, particularly those that may impact on some vulnerable customers, may be a significant social or public interest concern. In 2008 Energywatch, the Select Committee and the Government certainly felt that they were. The large suppliers themselves voluntarily offered social tariffs to vulnerable customers, until in 2010-11 the Government insisted these tariffs be replaced by its own Warm Homes Discount support programme which required a higher level of income transfer to specified pensioners and low income customers. As noted, Brennan (2007) explains how opening a market to competition may make some customers worse off. So a public interest concern may justify assistance to some customers or some other intervention in the market, though the potential adverse consequences of such intervention need to be acknowledged and assessed. But differential prices *per se* are not necessarily an indication of lack of competition, and in this case arguably the opposite.

### 13. The CMA and customer detriment

The CMA did not start by asking whether prices or profits seemed excessive. Rather, it started from Ofgem's reference document and the joint *State of the Market Assessment*, found that there was weak customer response, and then explored two methods to quantify the resulting customer detriment. These involved assessing whether prices or profits seemed excessive.

190. We have adopted two approaches to assessing the extent to which prices have exceeded those we would expect in a well-functioning market:

(a) a 'direct' approach, which involves comparing the average prices charged by different suppliers, while controlling for those differences in each supplier's customer base that are likely to affect costs; and

(b) an indirect approach, which involves assessing both: (i) suppliers' levels of profitability (and in particular whether the Return on Capital Employed by suppliers exceeds their cost of capital); and (ii) the extent to which suppliers have incurred costs inefficiently (i.e. whether costs are higher than we estimate an efficient supplier would incur). (p 45)

As noted above, the CMA's 'direct approach' calculation was that domestic energy customers suffered an annual detriment averaging £1.4 billion per year over 2012-2015, and almost £2 billion in 2015. Using its 'indirect approach' the CMA calculated that the detriment averaged £720m per year over the longer period 2007-2014.

Littlechild (2017, 2018) has elsewhere expressed concerns about the methodology, detail of calculation and procedure in this part of the CMA's *Final Report*. This section briefly summarises those concerns.

A conventional characterisation of a competitive benchmark price would be the cost of the marginal (least efficient or highest unit cost) plant required to meet the level of demand in the market. The CMA's predecessor - the Competition Commission - used such a definition in its examination of the cement industry. In contrast, the CMA defined the competitive benchmark price as the cost of the *most* efficient and *lowest* cost plant in the market. This increased - by an order of magnitude - the level of customer detriment defined via the CMA's direct approach, which sought to measure the difference between the actual price in the market and the competitive benchmark.

The CMA's indirect approach was also unusual and increased the size of the detriment. It added to the conventional excess profit calculation an estimate of inefficient cost. This included - in one variant - the whole of the difference between actual costs in the market and the lowest cost of the most efficient supplier.

This is not a methodology that the CMA or CC has used previously. It greatly increases the size of any detriment, and has problematic implications for economics more generally. For example, is the competitive market price to be represented, not by the intersection of the Supply and Demand curves, but by the intersection of the Supply curve and the vertical axis?

The details of the CMA's calculations were heavily challenged by the large suppliers. The CMA acknowledged that its benchmark was not the costs of an actual supplier, but 'a hypothetical construct, a 'supplier' that is a combination of the suppliers that we have identified as being the most competitive in the markets'. (CMA 2016 para 10.18 p 602) A series of major adjustments had to be made to their actual costs. In its direct approach, the CMA ended up comparing actual prices of the six large suppliers with the CMA's guess at what just two of the much smaller mid-tier suppliers would charge *if* they were not exempt from costly environmental obligations and *if*



they had reached an efficient scale and *if* they were in a steady state and *if* they were not loss-making and *if* instead they were earning a normal return on capital. (para 10.27) It was thus a comparison between actual prices and a purely hypothetical more efficient alternative.

Using its indirect approach, the CMA calculated excess profit to average £303m per year over 2007-2014. If the CMA had taken as its benchmark the actual return obtaining in the market for Industrial and Commercial customers, which the CMA regarded as so competitive not to require investigation, and had adjusted for the difference in risk between the two markets, then the alleged excess profit would be reduced by nearly a half to about £170m per year.

Furthermore, the CMA's calculation does not distinguish between excess profit and producer surplus. There is evidence of significant differentials in costs and profits between the six large suppliers, which suggests that producer surplus is significant. And the fact that two of the six large suppliers rather consistently made financial losses rather than profits over this period suggests that the average market price was below, rather than above, what would normally be regarded as the competitive market price. In other words, all of the alleged excess profit was likely producer surplus.

The CMA made several calculations of inefficient cost, using different benchmarks. Its preferred basis gave an average of about £720m per year over the period 2007-2014. But the CMA did not explain why it was appropriate to calculate and add inefficient cost, why cost differences were not a normal feature of all real competitive markets.

The CMA itself pointed out an important implication for policy. 'A large part of the detriment we have observed in the form of high prices is likely due to inefficiency rather than excess profits, such that if we were to eliminate the entirety of the detriment we have observed through a price cap it would create substantial losses for the sector as a whole' (CMA 2016, para 11.90).

Finally, as to procedure, there were arguments as noted about the CMA's calculations and adjustments. For example, Oxera (2017) argued that proper adjustments could more than wipe out the alleged customer detriment. During the investigation, suppliers' consultants were allowed access to the dataroom to analyse the CMA's calculations. However, the CMA's final report made two significant new adjustments, which Oxera estimated could be of the order of £1 billion, and these final critical adjustments were not available in the dataroom or subject to consultation, and their details were redacted in the final report. So no one other than the CMA panel knows what the CMA's final calculations actually were.

#### **14. The CMA and price discrimination**

The CMA concluded that the six large suppliers were exercising unilateral market power 'through price discrimination by pricing their standard variable tariffs materially above a level that can be justified by cost differences from their non-standard tariffs' (p. 39).

There is no doubt that the large suppliers were pricing their standard variable tariffs with materially greater margins above variable cost than their non-standard tariffs. They could do this because their customers' demand for these tariffs was less elastic than the demand for the non-standard tariffs. But this does not mean the large suppliers had or were exercising market power. Insofar as they were not making excess profits, their prices in general were not above the competitive level (and if anything could have been below, insofar as two of these suppliers were making losses). Even though the demand for standard variable tariffs was less elastic than for

non-standard tariffs, it was nonetheless sufficiently elastic to prevent the six large suppliers in aggregate from making excess profits.

A widely held view, in effect endorsed by Ofgem and the CMA, is that there is a two-tier market: those customers who engage in the market are protected by competition, and get ‘the competitive price’, but those customers who do not engage are not protected, and pay above ‘the competitive price’. The argument put forward in this paper challenges that interpretation. As explained elsewhere,

In order to survive and operate economically, most energy suppliers seem to need a combination of less engaged customers on higher tariffs and more engaged customers on lower tariffs. If all their customers are on a single high-priced tariff, they lose customers. If all their customers are on a single low-price tariff, they can’t cover their total costs. In either case, they would eventually go out of business. ... So in assessing whether a market is competitive, it is necessary to look at the whole range of prices, not only the lowest prices. (Littlechild and Smith 2017 s 2.2, p 6)

Engaged customers get lower prices, more hassle and less leisure time; less engaged customers pay higher prices but get less hassle and more leisure time. If both sets of prices enable suppliers to continue in business, but not make excess profits, then both sets of prices can be said to be at a competitive level. Of course, this is just a static picture: over time, competition is also reflected in suppliers with lower costs, more attractive products or better service gradually displacing their less competent rivals - as indeed is happening at present.

As explained above, price differentiation may raise public interest issues, especially in relation to vulnerable customers. But it does not necessarily indicate a lack of competition in the market.

## **15. Regulatory impact analysis**

Along with the Bill, the Department for Business, Energy and Industrial Strategy (BEIS) provided its Impact Analysis. The Regulatory Policy Committee (RPC, established to provide the government with external, independent scrutiny of new regulatory and deregulatory proposals) was somewhat critical.

In general, the evidence the Department presents in support of its rationale and selected option is weak, and even confused, moving from an approach grounded in efficiency to one based in equity without a clear argument. It also does not discuss whether it believes the loss to consumers who remain on variable tariffs arise as a result of super-normal profits, or through cross-subsidisation of other customers; given that the impacts of a cap will be different in each case. The Department should clarify its position. (Regulatory Policy Committee 2018 p 3)

These two criticisms relate to the two issues discussed in this paper. Equity is discussed in the following section. On the loss to consumers issue, the RPC seems to be suggesting that, if the loss arises from super-normal profits, then (to that extent) standard variable tariffs can be reduced without adversely affecting other tariffs and their customers. But if the loss arises from cross-subsidisation, then other tariffs will increase.

This paper suggests that the latter possibility is more likely, though it has not used the term cross-subsidy. As explained, the evidence does not suggest that, in aggregate, the large suppliers are making super-normal profits. Capping standard variable tariffs is likely to increase other (fixed) tariffs, for two reasons. If margins on a supplier’s various tariffs are simply contributing (albeit in different proportions) to a normal level of profit, then reducing margins on standard variable tariffs will necessitate increases in margins on other tariffs if the supplier is to continue to break even. (These increases could be offset by cost reductions, but such reductions could otherwise have translated into price reductions.) In addition, to the extent that suppliers are

setting low fixed tariffs in the expectation that a proportion of their fixed tariff customers will later become more profitable standard variable tariff customers, then capping standard variable tariffs will reduce or remove the incentive to set low fixed tariffs.

## **16. Fair tariff differentials**

An approach ‘based in equity’ or fairness is indeed once again a significant feature of the present debate. Ofgem (2008) acted to eliminate ‘unfair tariff differentials’, which it defined as tariff differentials that exceeded cost differentials. The CMA observed tariff differentials that it considered higher than consistent with a fully competitive market, but did not venture a view as to what differentials would be consistent. The Select Committee expressed hope that the large suppliers will start ‘treating their loyal customers more fairly in the future’ and says that one of the Bill’s two key goals is to ‘increase fairness’.

The Committee made several other references to fairness, notably the following.

‘32. ... Dermot Nolan [CEO Ofgem] told us that “in a competitive market that is working effectively, you would not expect to see huge differentials” between the highest and the lowest tariffs available in the market. ... We agree with Ofgem’s view that in a truly competitive market that works for all consumers and is fair, the differential between the highest and lowest comparable tariffs should be smaller.’ (House of Commons 2018b, p 14)

In his oral evidence, Nolan had said that, in assessing whether there was effective competition, Ofgem would look at a number of indicators, including ‘the level of variation in the market’. (House of Commons 2018a, Q345) He explained that

‘in an effectively competitive market, you should not see significant differentials, because it should not be possible for the company to charge in excess of what other people are paying, because it would lose customers and lose profitability. The CMA has talked through its analysis of differentials of £200 or £300.... I would talk about maybe £50 to £100 as being acceptable economically.’ (Q413,414)

How is the economically acceptable differential to be determined? It is not clear that anyone has ever attempted such a challenge. Presumably, in a competitive market, differentials between standard variable tariffs and fixed tariffs would reflect both demand and supply side considerations, not just cost differentials.

On the demand side, as Nolan said, is the extent to which different types of customer would be willing to accept price differentials before changing tariff or supplier. On the supply side would be a wide variety of factors such as the difference between spot wholesale prices for fixed tariffs and hedged wholesale prices for standard variable tariffs (which of course would change over time as wholesale market prices changed), the probability that new customers on lower fixed tariffs would later transfer to higher standard variable tariffs and how long they would stay, the level of customer costs to be covered (which would vary from one supplier to another), the extent of competition from other suppliers with lower costs, the existence and size of small-supplier exemption from environmental and social costs, the extent to which new entrants were underestimating their costs or overestimating their ability to stay in business, and so on.

The setting of tariff levels and differentials is a challenge that competing suppliers have to grapple with continually, but it is another matter for a regulator to determine what a competitive market would actually look like if the present one is deemed not competitive. It will therefore be interesting to see how Ofgem determines whether “conditions are in place for effective competition”, and in particular what constitutes economically acceptable tariff differentials.

## **17. Conclusion**

In 2008 Ofgem found that ‘the transition to effective competitive markets is well advanced and continuing’ but there were ‘some important areas where the transition to competitive markets now needs to be accelerated’. These related particularly to customers that were not sufficiently engaged in the market. Over the next several years Ofgem implemented a series of increasingly diverse and restrictive measures to address this issue, but without success. In 2014 it referred the sector to the CMA. In 2016 the CMA concluded that most of Ofgem’s measures had had an adverse effect on competition and should be withdrawn.

But the CMA essentially agreed with Ofgem’s diagnosis of the problem: it found that ‘weak customer response gives suppliers a position of unilateral market power concerning their inactive customer base’ which suppliers exploited through price discrimination and/or by pricing above efficient costs. It estimated that the resulting ‘customer detriment’ had averaged £1.4 billion per year over 2012-2015, rising to almost £2 billion in 2015. The CMA proposed various remedies to prompt more customer engagement, plus a temporary price cap on prepayment tariffs. It advised against a more widespread cap on standard variable tariffs, but a minority report supported such a cap.

In February 2018 the Government accepted the CMA’s findings. Repeatedly citing the £1.4 billion detriment, it introduced a Bill to require Ofgem to impose a cap on standard variable tariffs and other default tariffs.

The alternative view presented here is that the domestic retail market, when not restricted, has been broadly competitive. Significant price increases after the early 2000s reflected increases in underlying costs – wholesale costs, network costs and the costs of environmental and social policies – but *not* excessive retail profits. The much-cited CMA-calculated detriment is based on an unprecedented assumption that the competitive benchmark should be ‘a hypothetical construct, a ‘supplier’ that is a combination of the suppliers that we have identified as being the most competitive in the markets’. A more plausible calculation suggests that prices and retail margins in aggregate have not been significantly above what is normally regarded as a competitive market level. Price differentiation has provided lower prices to active customers, reflecting significant competition, not a lack of it. Competition has also protected the less active customers, insofar as prices are not in excess of suppliers’ costs in aggregate. Competition, not least from fast-growing new entrants, is putting pressure on the costs and prices of all suppliers.

In explaining the Government’s policy, the Minister said ‘It is considered to be a reset of the market. We think this market is moving in the right direction but not fast enough, and we want this to reset.’ (House of Commons 2018c, Q447)

It remains to be seen how Ofgem balances the various considerations in setting the price cap and, in due course, evaluates whether ‘effective competition’ would ensue if it were removed. It will thereby become apparent whether the Government’s attempt to reset the competitive market, and to accelerate the transition to effective competition, is any more successful than Ofgem’s policy was after 2008.

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