

## The CMA Energy Market Review: a remedy without a cause?

1. See <https://www.gov.uk/cma-cases/energy-market-investigation>. The investigation covers sales to domestic and very small business customers.

2. This retail activity comprises billing, consumer service and contractual functions but involves very few physical assets. The CMA finds little or no fault with the upstream operation of the market, or with the existence of vertical integration.

3. This gap between SVT and other tariffs has increased in recent years. The CMA also finds even higher prices for small enterprises ("micro-businesses"), estimated at 14% above the competitive level.

4. It is inherently difficult to construct robust profitability measures of this kind, which is one reason why the CMA's predecessors reduced their reliance on such analysis in the 1990s.

5. The basis for this critical finding is, however, controversial due to the difficulty of measuring capital employed and defining the "competitive" level for prices in an activity that has very low physical capital employed and few obvious benchmark comparators. The CMA also found a high variability between the profits of the different retailers. See Section 10 of the CMA report.

On 7 July 2015 the UK's Competition and Markets Authority ("CMA") published the provisional findings of its market investigation into the UK energy market.<sup>1</sup> It found an adverse effect on competition ("AEC") in the way in which energy companies retail gas and electricity to UK households. The final conclusions of the investigation are due by the end of 2015. This Brief examines the CMA's provisional findings and proposed remedies.

### The CMA findings

The UK domestic energy market is worth some £30bn per annum. Prior to the liberalisation of the UK energy market in 1999, one supplier, British Gas, supplied 100% of gas to domestic consumers and there were 14 regional electricity companies each with a monopoly of electricity supply in its own territory. Since then, gas and electricity retailers have been free to compete to supply both fuel types across all UK households. Various mergers within the industry have since whittled down the major retailers to the 6 major energy suppliers ("the Big 6") which together account for 90% of the retail market, but there are also 20 or so smaller suppliers in a fringe that has enjoyed steady recent growth.

15-20% of the average household bill of £1,200 is taken up with the retail margin; around 50% comprises the wholesale cost of energy; and the remainder comprises various network, environmental and social costs. A 25% increase in energy bills between 2009 and 2013 had led to a barrage of consumer, media and political complaints about the energy market, and prompted the market investigation, under which the CMA has a duty to examine factors that lead to an AEC, and broad powers to implement remedies.

Interestingly, however, although the recent price increases were due primarily to wholesale market developments, the AEC concerns in the CMA's provisional findings focus almost entirely on the retail activity.<sup>2</sup>

A variety of tariffs are available in the market, but the most important distinction is between the standard variable tariff ("SVT") offered as the default option by each of the Big 6, and their fixed price contracts that are offered to consumers who shop around. One of the key features found by the CMA is the dichotomy between consumers who have exercised their right to switch suppliers, and those who have remained inert. In a survey commissioned by the CMA, 56% of consumers claimed never to have switched supplier, and some 70% of the customers of the Big 6 retailers continue to be supplied on SVT terms despite the fact that they could typically achieve savings of between 12% and 18% by opting for one of the available fixed price offers.<sup>3</sup>

Crucially, the CMA then relies on an analysis of industry profits to conclude that this "weak consumer response" to retail competition leads to uncompetitive outcomes and an AEC.<sup>4</sup> Taking account of a variety of different measures, and relying on a number of heroic assumptions, the CMA concludes that the profitability of the retail industry is well in excess of its cost of capital.<sup>5</sup> It concludes that the prices of the Big 6 to domestic consumers were on average 5% above the competitive level, and that the gap between the retailers' actual return on capital and their cost of capital amounts to £900m per annum.

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6. See para 123. The CMA also expresses concern with the fact that household energy meters are not visible to consumers on a day to day basis, but as long as the bills they receive are visible, it is hard to see why that feature should preclude switching.

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7. See para 118. At para 120 the CMA notes that it might have been more relaxed about the lack of switching had the demographics of the group been different.

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8. This conclusion does not (just) rest on a value judgment about the inequity of the winners and losers being different groups, but rather on the fact that the lack of connection between the groups also means there is no competitive mechanism to ensure that the “investment” that retailers make in low prices will compensate the “return” they recoup from the higher priced segment.

## Factors behind the provisional findings – who is at fault for the AEC?

It is one thing to find that competition in the energy market is not working well, but quite another to identify the reasons behind this outcome, and (having done so) to devise suitable remedies to fix the problem. The CMA explores a variety of possible causes.

### Consumers?

One view is that consumers themselves – and specifically those who have not taken up the option to switch to a more competitive tariff – are to blame for the failure of the market to deliver competitive outcomes. The CMA examines the possible reasons for consumers’ lack of “engagement” in the energy market.

The CMA claims that the homogeneity of the product makes consumers less willing to switch. However, this view is unconvincing as that feature ought to make it far simpler for consumers to choose between the prices on offer. Given that the financial stakes are high (energy bills can account for 10% of household expenditure) consumers ought to have a strong incentive to take the available options to pay less for their energy.<sup>6</sup>

One possible hypothesis is that the consumers who continue to be supplied on SVT terms are “cash rich, time poor” and thus make a rational decision not to switch even though savings are available. But the CMA rejects this explanation decisively, showing that the class of inert consumers is drawn disproportionately from those with lower income and education levels.<sup>7</sup> Hence, the CMA concludes that the failure of consumers to switch suppliers is due to lack of information on the options, or to a perception that the costs and hassle of switching are high.

### Energy companies?

Could the energy companies themselves be at fault for this problem? In other markets, notably in the financial services sector, suppliers have been accused of deliberately making products and conditions excessively complex and/or exaggerating the risks associated with switching. In energy retailing, there is a complex array of tariffs, but the CMA does not put this down to a retailer conspiracy.

Much of the media commentary on the energy sector, which provided a backdrop to the investigation itself, contained loose (and unsubstantiated) allegations of collusive conduct as an explanation for high prices. However, the CMA rightly notes that recent increases in prices relate primarily to competitive developments in the wholesale energy market that have nothing whatever to do with the retail activity, and it finds no evidence of either the existence or likelihood of tacit collusion.

Rather, the CMA’s explanation is much more straightforward – it concludes that energy retailers simply recognise the inertia in a section of their customer base and, in view of the much reduced threat of losing such consumers, have adapted by raising SVT prices and margins to what this part of the market will bear. Simultaneously, the same retailers have taken steps to attract and retain the business of consumers who do show a propensity to switch by offering them fixed price deals on much keener margins. The CMA does not specifically condemn the retailers for the resulting pattern of price discrimination, but it describes the high SVT prices as the “unilateral exercise of market power” over this segment of the customer base.

Some of the energy retailers have sought to counter this criticism by arguing that there is a competitive relationship between the low prices on fixed price deals and the high prices and margins on the SVT. The argument would work best if consumers switch to obtain a time limited low price and then, when the product feature ends, default to paying the higher SVT. In that case, competitive rivalry might provide low enough prices to switching consumers to “refund” or compensate any excess profits they reap from the inert SVT customer group. However, the CMA notes that where switching is low, some consumers may never switch to the good deal at all, while those that do are potentially too few for their gains to make up for the harm suffered by the larger inert group.<sup>8</sup>

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9. Other measures, such as curbs on aggressive sales techniques, may also have reinforced this diminution in competitive intensity.

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10. However, Ofgem escapes formal CMA censure for this pricing rule on the grounds that it has recently been rescinded.

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11. A total ban on all price differentiation might in theory solve this problem, but could impose the far greater cost of stifling innovation and providing a focal point for tacit collusion between the suppliers.

## Regulators?

The striking aspect of the report is the extent to which the CMA holds the UK energy regulator, Ofgem, accountable for the failure of competition in energy retailing. There are a number of strands to this criticism of Ofgem's well-intentioned but ultimately counter-productive efforts to manage retail market competition.

The first relates to a rule, introduced by Ofgem in 2009, to ban regional price discrimination by the energy companies. This rule was motivated by the regulator's dislike of the inequity between the high prices charged to incumbent consumers in their "home" territories and the low prices offered elsewhere, but the economic logic behind it was flawed. The ban on geographic price discrimination essentially imposed a "cost" on the retailer winning new business outside its home territory, since to chase such business the retailer would be forced to concede the attractive margins it was earning on sales to loyal customers in its home territory.

Unsurprisingly, energy retailers were reluctant to cut prices to the loyal customers who continued to show a willingness to pay high margins in their home territories, and so this ban on geographical discrimination actually reduced the intensity of competition for new business. It also provided an incentive for the retailers to find other ways to differentiate tariffs. The result has been a situation of second-degree price discrimination in which the loyal (or simply inert) and footloose customer groups have revealed themselves by their choice of tariff. This alternative form of market segmentation has probably contributed towards the recent growth in the gap between the SVT and other tariffs on which the CMA's finding of an AEC is based.<sup>9</sup>

The CMA concludes that Ofgem's ban on geographic price discrimination has played a significant role in allowing SVT prices and margins to rise independently of fixed prices.<sup>10</sup> Paradoxically, allowing such discrimination to flourish would have been a more effective way to enable competition to bid away the high margins that retailers earn on their incumbent customers.<sup>11</sup>

Second, the CMA comments critically on the most recent Ofgem moves to limit the number of tariffs that can be offered by the energy retailers. This move, which was intended to reduce complexity and thus to make switching easier, has inadvertently also forced energy companies to discontinue some tariffs that offered some consumers a better deal. Even with the reduced number of tariffs available in the market, however, the consumer is faced with a huge number of options and probably needs to use an intermediary such as a price comparison website ("PCW") to assist in searching and choosing the best tariff. Hence, the CMA believes that the costs of reducing complexity probably outweigh the benefits.

Finally, the CMA discusses the policy dilemma raised by Ofgem's moves to force PCWs to provide comprehensive price information on the prices of all suppliers and their tariffs. This rule was designed to ensure that consumers can be confident that their PCW search results are comprehensive, but in practice it has meant that PCWs are obliged to include the prices even of suppliers with whom they have no contractual arrangements. Since the business of a PCW is driven by the commissions earned from the successful supplier when the consumer uses that PCW to effect a switch, this obligation could encourage free-riding by suppliers who choose not to pay PCW commission, safe in the knowledge that the PCW is in any case obliged to display their tariffs.

The CMA remains on the fence on this issue on the grounds that it is not yet clear what effects this free-riding problem has had on the market. But again this consumer-focused Ofgem ruling presents an obvious risk that regulatory action will serve to dampen the vigour with which PCWs, who seem bound to play a vital part in encouraging consumers to switch, will engage in the domestic energy market.

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12. Indeed, the CMA's discussion of price controls refers to the pitfalls of such measures – see paras 92-93 of CMA remedies discussion.

### Remedies?

The CMA is obliged to suggest remedies when it finds an AEC, and its provisional findings include a long and diverse menu of options. At one end of the spectrum, proposals to provide more information and written prompts to consumers who remain on the SVT appear sensible measures to encourage consumers to be more aware of the benefits that competition can provide.

At the other extreme, however, it is surprising that the CMA gives serious consideration to imposing controls that would place a “temporary” ceiling on the SVT of each energy retailer. Whatever imperfections might exist in energy retailing, they scarcely match up to the severe market failure associated with the natural monopoly sectors for which price control measures are normally reserved, and price caps are likely to blunt the incentives that would drive a competitive solution to this problem.<sup>12</sup> More importantly, if the CMA is confident in its own assessment that misguided regulatory rules on pricing are responsible for the recent divergence between the SVT and more competitive tariff options, it would seem far preferable to allow the market to find its own competitive solution once those regulatory errors have been undone.

In recognition of the unintended consequences from prior attempts to outlaw price discrimination, the CMA's remedies options clearly reject any further attempts to control such practices.

### Conclusions

The CMA's energy market investigation illustrates some key features of the UK market investigations regime.

On the positive side, it shows the ability of these investigations to take a detached look at the imperfections in a market and to undertake a more rounded analysis than is possible within the framework of prohibition-based competition law instruments such as Articles 101 and 102. Similarly, the ability to consider a variety of possible causes is valuable, and the CMA's preparedness to lay much of the blame for the identified market failures on well-intentioned but misguided regulatory decisions is refreshing.

But the CMA's provisional findings also highlight more controversial features of the UK regime. The extremely wide discretion allowed to the CMA in reaching an AEC finding sets the bar for intervention very low. The finding of an AEC in this case rests on the evidence that some consumers have been slow to take up opportunities to benefit from lower prices, despite the fact that the retail energy market has multiple competing suppliers and that switching is evidently feasible. Where inert consumers are widespread and make it harder for firms to gain share with competitive offers, careful intervention may in some cases be warranted to facilitate switching processes and/or to nudge consumers to switch. However, consumers who search and switch rarely are found in many retail markets and it is often far from clear how to change their behaviour “for the better” or indeed whether an attempt to do so would simply make things worse.

With the CMA's very broad remit to find AECs comes a wide range of remedy powers. The CMA shows great confidence in its ability to find and implement remedies in the energy market, including the possible use of draconian price regulation provisions that are normally found only in cases of chronic monopoly power. While it might be tempting to believe that consumers who cannot protect themselves should be protected by price regulation, the risk of entrenching the absence of switching, potentially dampening competition, surely cautions against such measures. Having spent much of the report cataloguing the failures of Ofgem's efforts to micro-regulate the energy market, the CMA should be wary that its own proposed price control remedies could create equal or greater unintended adverse consequences.