Mr Roger Witcomb
Chair, CMA energy market investigation panel

20 February 2015

Dear Roger

Operating cost variations in a competitive market

I am disappointed to see that the wretched well-functioning market has crept into one of the recent CMA working papers. More importantly, it reflects an analysis in the *State of the Market Assessment* that is at best incomplete, and at worst misleading, in three respects:

- economic theory does not imply, as claimed, that operating costs of suppliers in a competitive market will converge over time
- as it happens, however, the evidence presented in the *Assessment* suggests that operating costs of the major suppliers *did* converge over the period 2009 – 2012, arguably by more than the "little convergence" referred to in the *Assessment*
- the extent of cost differences between major suppliers, and the extent of convergence, reflect the impact of state ownership of one major supplier as well as the extent of competition; after removing that comparator the extent of cost difference is markedly less than indicated in the *Assessment* and the convergence over time is markedly greater than indicated there.

What the working paper data for 2007 – 2013 show is yet to be revealed. However, neither economic analysis nor the data in the *Assessment* suggest that the differences and trends in operating cost are inconsistent with a competitive market.

Sincerely

Stephen Littlechild

The working paper proposition

The relevant passage in the recent working paper is the following.

> 77. In a well-functioning market, all things being equal, we would expect competition to drive market participants to improve services and seek efficiencies. These efficiency gains should manifest themselves in reduced costs, and *over time the gap between the highest and lowest cost suppliers should converge*. (Profitability of retail energy supply: profit margin analysis, 16 March 2015, italics added)

Apart from the italicised phrase, the two sentences could easily and more helpfully be recast as follows.

> In a competitive market, we would expect competition to drive market participants to improve services and seek efficiencies. Other things being equal, these efficiency gains should manifest themselves in reduced costs.

These are reasonable propositions, consistent with economic theory and evidence. The CMA can investigate whether those things are happening (making allowance where necessary for exogenous increases in cost determinants etc). There is no need for the ambiguous concept of a well-functioning market.

That leaves the proposition

> In a competitive (or well-functioning) market, the gap between the highest and lowest cost suppliers should converge over time.

Where does this claim originate? It was not mentioned in Ofgem's *Decision to Make a Market Investigation Reference* (June 2014 para 3.32), or in the CMA's *Initial* or *Updated Issues Statements*. It was asserted in the *State of the Market Assessment* (March 2014): "The variation in indirect costs among the major suppliers has remained significant over time with little convergence in costs, as one might expect if competition were driving down costs to the efficient level over time." (para 6.37) The *Assessment* also mentioned a similar claim by the IPPR publication on *The True Cost of Energy* (April 2012 section 2.3.1). The IPPR in turn referred back to the *Initial Findings* of Ofgem's Probe (October 2008, para 7.86). Ofgem there noted "a wide range of operating costs per account, with the cost per account of the highest cost supplier around 90 per cent higher than those of the lowest". It said "this evidence is not consistent with an effectively competitive market, where we would have expected such material cost differences to have been competed away".

There are three problems here, associated with the claim about economic theory, with the description of the evidence in the *State of the Market Assessment*, and with the effect of ownership on the market.

Economic theory

So far as I know, there is no economic theory or empirical evidence to support the general proposition that in a competitive market the gap between the highest and

lowest cost suppliers should converge over time. Nor is there any mention of this proposition in the CMA's *Guidelines for market investigations*.

As the CMA appreciates, competition is not a gradual transition to a long run market equilibrium which – under certain unrealistic assumptions such as "the efficient level of cost" being static – might indeed be characterised by a converging gap between the highest and lowest cost suppliers.

Rather, competition is a rivalrous discovery process taking place over time. The participants have different abilities. The process is characterised by learning but also by errors. Market conditions are changing constantly and unpredictably – not least, in this case, as a result of changing regulation. Of course high cost suppliers will be wanting and trying to reduce their costs. Some will manage to do this, others will fail and eventually perhaps leave the market. But at the same time low cost suppliers will be wanting to stay ahead of the game, and exploring ways of further reducing their own costs.

Certainly there will be periods – for example, during financial crises - when the higher cost suppliers will make particularly strong efforts to reduce their costs, and for such periods costs may converge. But there will also be other periods – for example, at times of expanding demand and/or innovation and new entry – when costs might diverge. In yet other periods the relative rankings of particular suppliers might change without much change in the range between highest and lowest cost supplier. And there might be some periods when nothing much at all happens.

Reducing operating costs in the retail energy sector seems to have been a complex and difficult process. Suppliers have invested in a range of new systems in order to improve service and reduce costs, some of these seem to have been successful, others have failed and been abandoned. The CMA will no doubt be exploring this with the suppliers. But it suggests that there is no straightforward way for the higher cost suppliers to converge their costs to those of the lower cost suppliers.

Thus, unless the CMA can produce some supportive economic theory, and empirical evidence showing that convergence occurs systematically in other markets, it seems difficult to argue that a particular level of difference between the highest and lowest cost suppliers at one particular moment in time, or the absence of any convergence over a (relatively short) period of time, is evidence of a market that is uncompetitive (or not well-functioning).

The description in the *State of the Market Assessment*

Is it actually the case that the cost differences between major suppliers are substantial and are not reducing over time? The CMA's profit margin analysis working paper is apparently based on data for the period 2007 – 2013 but all the numbers have been excluded in the published version. So consider what the *State of the Market Assessment* had to say for the period 2009 – 2012.

> 6.37 … The supplier with the highest costs had total indirect costs that were 76 per cent higher than the supplier with the lowest costs in 2012 and 32 per cent higher than the average for the six largest suppliers. The variation in

> indirect costs among the major suppliers has remained significant over time with little convergence in costs, as one might expect if competition were driving down costs to the efficient level over time.

If the cost calculations are comparable, then the 76 per cent higher in 2012 is less than Ofgem's reported 90 per cent higher, which seems to refer to 2007. This is arguably more than a "little convergence in costs".

The *State of the Market Assessment* then continues as follows.

> 6.38. We considered whether the variations in costs might be caused by different bad debt or customer acquisition costs. We found that, even after excluding these costs, the divergence in the indirect cost per customer for the six largest suppliers remained, and that the gap between the supplier with the highest costs (EdF) and the average widened considerably.

This might be read as saying that the divergence in indirect costs remained roughly constant over time, and that the gap between the highest-cost supplier and the average cost widened considerably over time. This is not in fact the case: a closer reading suggests that the comparison in both cases is between the operating costs excluding and not excluding bad debt and customer acquisition costs. This raises the question at issue here: what actually was the extent of change over time?

The *State of the Market Assessment* does not give the actual data, but its Figure 50 does show a graph of indirect costs per customer, excluding bad debt and acquisition costs, adjusted for inflation, for each of the major six suppliers separately, over the period 2009 to 2012. Reading by eye, this graph seems to show the following:

- the highest-cost and lowest-cost per customer were about £156 and £76 respectively in 2009, and £143 and £78 respectively in 2012. Thus the gap between highest and lowest cost reduced from £80 to £65, or from 105% to 83% of the lowest cost;
- the average cost reduced from £110 in 2009 to £106 in 2012, so the highest cost was 42% above the average cost in 2009 and 35% above it in 2012.

Whether these constitute "little" convergence is a matter of opinion, but there was convergence and it was not negligible.

The effect of ownership

The third problem with the suggestion that the difference in costs is greater than would be observed in a competitive market, and that costs should converge over time, is that it presumably assumes a competitive market with privately owned suppliers. Yet one of the suppliers is EdF, which is 84.5% state-owned. Economic theory says that state-owned companies will place less weight than privately-owned companies on profit, and by implication on taking steps to reduce excessive costs. There is substantial empirical evidence on the effects of ownership, which is not unanimous but on balance is consistent with this.

It is therefore not surprising that Figure 50 shows that the supplier with the highest operating costs in every year over the period 2009 – 2012 was EdF. It is also notable

that the other five major suppliers felt a need to make a profit on their retail business, and generally did so over that period, but EdF did not.

More precisely, Figure 46 shows that four of the six largest suppliers (Centrica, E.On, Scottish Power and SSE) achieved a positive EBIT margin on their combined retail business electricity and gas supply in every year during 2009-2012. A fifth large supplier (NPower) made a large loss in 2009 but reduced this loss then steadily improved its EBIT margin. In contrast, EdF made a loss in three of the four years, and only a small positive margin in the other year. In the final year 2012, the five privately owned suppliers secured positive EBIT margins in the range 2.5% to 6.6% on revenue, whereas EdF's margin was negative, at - 1.4%.

For present purposes, the significant implication is that the range and change of costs that Ofgem and the CMA have identified do not reflect simply the extent of competition in the market: they reflect also a difference in ownership. To understand the picture without the distortion of public ownership, consider the costs of the five major privately owned suppliers excluding EdF. Figure 50 then shows the following:

- the highest-cost and lowest-cost per customer (excluding EdF) were about £136 and £76 respectively in 2009, and £116 and £78 respectively in 2012. Thus the gap between highest and lowest cost reduced from £60 to £38, or from 79% to 49% of lowest cost;
- the average cost (excluding EdF) reduced from £108 in 2009 to £102.5 in 2012, so the highest cost was 26% above the average cost in 2009 and 13% above it in 2012, a reduction to half the previous level.

Conclusions

The *State of the Market Assessment* argued that a competitive market would be characterised by cost convergence. It noted that the supplier with the highest operating costs in 2012 had total indirect costs that were 76 per cent higher than the supplier with the lowest costs, and 32 per cent higher than the average for the six largest suppliers. It also said that the variation in indirect costs among the major suppliers had remained significant over time with little convergence in costs.

The claim that a competitive market is characterised by cost convergence is untenable. But as it happens, the evidence in that same *Assessment* suggests that, after removing the distorting effect of majority public ownership of one major supplier, the highest cost supplier was only 49% above the lowest in 2012, and only 13% above the average. There was also a marked convergence in costs since 2009, from 79% to 49% between highest and lowest, and a halving from 26% to 13% between highest and average.

This is a quite different picture from the one painted by the *State of the Market Assessment.* Even by the proposed (but faulty) criterion, observed cost differences and their change over time do not suggest a lack of retail competition in the retail energy market. It remains to be seen what the data show for the longer period 2007 to 2013. But given that significant cost convergence cannot be expected in real competitive markets, and given also the difficulty of ensuring comparable operating cost figures when suppliers offering different services from the same cost base may allocate costs differently, it would not be sufficient to find the retail market

uncompetitive simply on the basis that observed cost differences "seem high", and seem to exhibit "little convergence". As in other respects, the CMA needs to consider whether experience in the retail energy market is significantly different from – and worse than - that in other actual retail markets.