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Dear Will

**Submission on Summary of Provisional Findings Report and Notice of Possible Remedies**

We former energy regulators previously submitted responses to the CMA in August 2014 and February 2015. We now submit our views on the *Provisional Findings Report* and the *Notice of Possible Remedies*.

From:

Stephen Littlechild, Director General of Electricity Supply and Head of the Office of Electricity Regulation (Offer) 1989-1998

Sir Callum McCarthy, Chairman and Chief Executive of Ofgem and the Gas and Electricity Markets Authority (GEMA) 1998-2003

Eileen Marshall CBE, Director of Regulation and Business Affairs, Offer 1989-1994; Chief Economic Adviser and later Deputy Director General of Ofgas 1994-1999; Managing Director, Ofgem and Executive Director, GEMA 1999-2003

Stephen Smith, senior executive positions at Ofgem 1999-2002 and 2003–2010 including Managing Director, Markets, 2004-2007 and Executive Board Member, GEMA 2004- 2010

Clare Spottiswoode CBE, Director General of Gas Supply and Head of the Office of Gas Regulation (Ofgas) 1993–1998.

## Summary of submission

- i. We have previously urged the CMA to examine the significant change in Ofgem's regulatory policy since 2008 and the impact of that change on competition.
- ii. We welcome the CMA's finding that numerous important aspects of the energy sector are generally not a problem. We note the finding that other aspects do have an adverse effect on competition, and with some important exceptions we consider that the proposed remedies are appropriate.
- iii. The CMA finds that the "simpler choices" aspect of RMR regulation has had an adverse effect on competition. We believe that this finding is justified, and we welcome the proposed remedy to remove these obligations on suppliers.
- iv. But we have grave concerns about the CMA's analysis of customer engagement and over-charging, and about its recommended reintroduction of price controls.
- v. The CMA argues that customers ought to realise that energy is a homogenous good and ought to focus mainly on price. Since the evidence shows that many customers do not act in this way, the CMA regards them as acting inconsistently with a "well-functioning market". We have previously urged the CMA to look at real markets, for other products and in other countries. The CMA has not done so. Its arguments about customer engagement and weak customer response are therefore unpersuasive, and lead the CMA to inappropriate and undesirable policy recommendations.
- vi. The CMA considers that domestic consumers are not sufficiently engaged to enable a competitive retail market to work. They must therefore be nudged into more active engagement. But they may not respond, so they must be forcibly moved onto another tariff set by the CMA or Ofgem. The CMA concedes that this could have adverse consequences, but insists that it has to be done.
- vii. This is yet another change in regulatory policy, and in an even more interventionist direction than the regulatory policy of the last 7 years. The notion that customer engagement is insufficient for a competitive retail energy market to work is out of touch with competitive retail energy markets around the world. The CMA's analysis and recommendations are not based on a realistic view of how customers behave, and how their interests are best advanced, but on a theoretical view of how the CMA thinks they ought to act in a hypothetical "well-functioning market".
- viii. The proposed price control – a safeguard price cap or default tariff - has serious disadvantages. It will restrict competition and militate against the CMA's other remedies to increase customer involvement. It will increase regulatory uncertainty and hence the cost of capital, and hence prices to customers. The recommendation also ignores the practical and political implications of such intervention.
- ix. The CMA says that a price control with headroom above cost has been used in New South Wales. The regulatory body there has been removing price controls, not reintroducing them into an already-competitive market, and is quite explicit that price controls are unnecessary and restrict competition.
- x. Similarly, the Australian Energy Market Commission argues for the removal, not the introduction, of price controls, saying also that maintaining

price regulation is likely to cause more harm than good. The International Energy Agency is also very critical of price controls, emphasising their adverse effect on competition.

- x. The CMA alleges £1.2bn over-charging in the domestic retail sector. Its calculations are based on a hypothetical “well-functioning market” in long run perfectly competitive equilibrium. The assumptions underlying its calculations are not revealed. Its calculations seem inconsistent with the average level of profit actually earned in this market, which was less than £1.2bn. Are firms in a “well-functioning market” supposed to operate at a loss?
- xii. The CMA fails to explore the reason for the significant increase in profits after 2008 and implies that it was due to lack of customer engagement. The CMA fails to acknowledge that regulatory interventions since 2008, which it finds have restricted competition, were very likely an important reason for the increase in profits. If it had acknowledged this, the CMA would have had to acknowledge that removing those interventions would increase competition and reduce profits, which would undermine the case for reintroducing price controls.
- xiii. The CMA finds that Ofgem’s non-discrimination condition contributed to a softening of competition. We welcome this confirmation. We also welcome the present rejection by Ofgem, and by the CMA, of non-discrimination conditions as a regulatory policy. There is considerable price differentiation in real competitive markets, to the benefit of customers. But the CMA seems to find that the Six Large Energy Firms were able to exercise market power by setting price differentials that exceed cost differentials. The CMA needs to clarify its thinking here.
- xiv. We see no case for the CMA’s proposal that Ofgem should operate a price comparison website. It would not increase trust in existing websites, in practice it would not be more authoritative, and it could reduce or distort competition in that market.
- xv. We urge the CMA to consider more explicitly what could be done to help vulnerable customers. We suggest the Standards of Conduct and the Price Comparison Website Confidence Code be modified to allow parties to develop more effective and appropriate face-to-face marketing practices, particularly for vulnerable customers.
- xvi. Given that the CMA has found that Ofgem’s regulatory interventions since 2008 have had an adverse effect on competition, care is needed in any further interventions. We urge the CMA in framing any remedies to make maximum use of trials of any significant remedies before implementing them. Any remedies in licences should have sunset clauses so that Ofgem would have to justify any continuation, with suppliers and others having a right of appeal.
- xvii. In sum, there is useful material in the Provisional Findings Report, particularly the finding that Ofgem’s “simpler choices” policy has an Adverse Effect on Competition and the recommendation to remove it. But it is not a plausible and proportionate recommendation to reintroduce price controls in the domestic retail energy market, when that energy market, before Ofgem’s change of policy in 2008, was the most competitive retail domestic energy market in the world.

## 1. Background

1. We former energy regulators wrote to the CMA on 7 August 2014. We expressed our concern that an industry that Ofgem deemed in July 2007 to be characterised by vigorous price competition was in 2014 the subject of serious criticism, not least by Ofgem itself. We supported the decision to refer the sector to the CMA and commented briefly on some of the points in the *Statement of Issues*. In particular, we drew attention to the significant change of direction in Ofgem's policy in 2008. We welcomed the CMA's commitment to base its assessments on actual markets and not on an idealised notion of a perfect market. And we urged the CMA to take account of the situations of vulnerable customers.
2. On 24 February 2015 we generally welcomed the development of the CMA's thinking in its *Updated Issues Statement* and urged the CMA to explore a few points further. A central issue was whether and in what respects the sector was "exceptional". We suggested that energy price increases *had been* exceptionally high since 2004, mostly for reasons beyond the control of the energy suppliers, but this nonetheless aroused great public concern. Compared with other markets, customers were *not* exceptionally inactive in the energy sector *nor* were price differences there exceptionally great. *Nor* was the behaviour of the energy suppliers exceptional insofar as differentiation of prices, market segmentation and lower prices for more active customers are normal features of a competitive market. However, regulatory interventions since 2008 *had been* exceptional, and these interventions had the unintended effect of reducing competition and increasing prices, not least to those vulnerable customers that it was intended to benefit.
3. We hoped that the CMA would accept this analysis and remove the restrictions on suppliers introduced by Ofgem's 2008 change of direction in policy. We suggested that the CMA instead focus regulatory action on facilitating access of vulnerable customers to the benefits of a competitive market, rather than limiting the ability of the competitive market to provide those benefits in the first place.
4. We now write to comment on the CMA's *Summary of provisional findings report* (SPF) and its *Notice of possible remedies* (NPR), both dated 7 July 2015. As before, we focus on the domestic market, though analogous principles apply with respect to the microbusiness sector.

## 2. General view

5. In many respects, we welcome both these CMA documents. The SPF provides a clear and comprehensive review of the energy sector. It preliminarily finds that numerous important aspects of the market – notably the wholesale electricity and gas markets, the self-dispatch system in electricity, vertical integration and tacit coordination – are generally not a problem. We welcome these findings, which ought to provide reassurance to the general public.
6. The CMA also preliminarily finds that certain aspects of the sector have an adverse effect on competition. These include the absence of locational prices for transmission losses and constraints, DECC's mechanisms for allocating Contracts for Differences (CfDs) related to renewables, the absence of a plan for moving to half-hourly settlement in the domestic electricity market, a lack of robustness and transparency in regulatory decision-making, and aspects of regulatory code governance. In all these respects we agree with the CMA on the adverse effects and generally consider that the proposed remedies are appropriate.

### 3. The effect of the change in retail regulation

7. We welcome the CMA's examination of the effect of the change in Ofgem's regulation that began in 2008. It has been a prime concern of ours that this be fully investigated. The CMA summarises the main changes in regulation.

87. ... Over the last six years, three major interventions by Ofgem have changed the nature of retail competition significantly: (a) The prohibition on regional price discrimination introduced in 2009. (b) The introduction of new licence requirements, standards of conduct and enforcement action resulting in the withdrawal of the Six Large Energy Firms from doorstep selling in 2011 and 2012. (c) The introduction of Retail Market Review (RMR) reforms in 2014 introduced a number of obligations on suppliers, including several provisions relating to tariffs, notably restricting the number of core tariffs.

8. We return later to the first two interventions. On present RMR policy the CMA concluded:

146. Overall, **our provisional finding is that the 'simpler choices' component of the RMR rules, (including the ban on complex tariffs, the maximum limit on the number of tariffs that suppliers are able to offer at any point in time, and the simplification of cash discounts) is a feature giving rise to an AEC in the retail supply of electricity and gas to domestic customers**, through reducing retail suppliers' ability to innovate in designing tariff structures to meet customer demand, in particular, over the long term, and by softening competition between PCWs.

9. These are strong findings, but we believe they are justified. We therefore strongly welcome the CMA's proposed *Remedy 3 – Remove from domestic retail energy suppliers' licences the 'simpler choices' component of the RMR rules*. We believe that this will address the concerns that have increasingly been raised about weak retail competition and lack of innovation. It will once again be possible for suppliers to design tariff structures to meet the different circumstances of different customer groups, not least vulnerable customers of various kinds.
10. Given the provisional finding that the "simpler choices" aspect of the RMR regulations have had an adverse effect on competition, we do not consider that it is sensible to ask whether a higher limit on the allowed number of tariffs would address the problem. (NPR para 51d) And Para 51(a) asking respondents to predict what additional tariffs energy suppliers would be likely to offer fails to understand the nature of the competitive discovery process that the main recommendation aims to enable.

### 4. Grave concerns about the CMA's analysis and price control proposal

11. If the CMA had left the analysis here, it would have provided an excellent and persuasive account of the problems and non-problems in the energy sector, along with credible remedies for addressing the identified adverse effects on competition. But it didn't. The CMA embroiled itself in a misleading discussion about the nature of customer engagement and in some questionable calculations of overcharging customers. It failed to appreciate the significance of its finding that Ofgem's regulations had restricted competition. It was thereby led to propose a safeguard

price control which would seriously restrict competition. We have grave concerns about the CMA's analysis and about this recommendation. The next sections of our submission set out our concerns on this and related matters.

## 5. Customer engagement and weak customer response

12. In discussing the nature of retail market competition, the CMA says, "Gas and electricity are extreme examples of homogenous products in that the energy that customers consume is entirely unaffected by the choice of retailer." (SPF para 82)
13. It is true that the physical energy is the same, except insofar as the terms of the customer's contract might limit the amount consumed (eg via prepayment meter). But in understanding how markets work it is necessary to look at the situation from the customer's perspective. Physical energy is only part of the product or service purchased and consumed. For customers, other significant differences relate to type and level of tariff, means and timing of payment, quality of service and any other benefits provided (or not provided), customer interface, marketing activities, trust or otherwise in the retailer, and not least of all familiarity and past history of relationships between the supplier and the customer. The relevant choice that the *customer* makes *is* affected by the choice of retailer.
14. The CMA continues, "We would expect, therefore, that price would be the most important product characteristic to a customer in choosing a supplier and/or tariff". (para 82)
15. This expectation is inconsistent with the evidence on how customers behave. Price may well be the most important product characteristic to those customers who are actively contemplating changing their supplier, or who are actively looking to reduce their energy bill, or indeed to those customers whose eye is simply caught by the offer of a significant price reduction. But price is evidently not the most important characteristic to the many other customers who choose to remain with their current supplier or tariff even when it is not the cheapest in the market. An Ofgem customer survey produced a striking example of this: 70% of customers said they didn't trust other suppliers but they did trust their own supplier.
16. The CMA then proceeds (paras 85-86) to describe what it would expect competition to be like in a "well-functioning market". Instead of looking at how competitive markets actually operate, the CMA looks to the theoretical ideal of a perfectly competitive market in long-run equilibrium. Using that model, the CMA imagines what competitive retail energy markets would or should look like – in effect, what it would like them to look like, what it thinks would be "nice to have".
17. Ofgem was previously led into problems with customer engagement because it took a similar stance. We expressed concern about this in our first submission.

15. We therefore urge the CMA not to interpret a "market that works well for customers" as licence to specify a series of features that it would be "nice to have" but that may not be feasible to achieve or that may be achievable only at disproportionate cost, or with unintended consequences that harm customers and competition. Similarly, a realistic approach to assessing effects on consumers, and behaviour of customers, implies setting aside purely theoretical and empirically unsubstantiated assumptions about how consumers might or should behave, and focusing on evidence about how they actually do behave.

18. We urged the CMA to look at other actual competitive markets – for example, the GB retail market until 2008, the retail markets overseas that are competitive, or the GB markets for other products. The CMA does not appear to have done this.
19. The CMA describes the results of a survey that it says “provides material evidence of domestic customers’ lack of understanding of, and engagement in, retail energy markets”. (para 89) It says “that there were significant gains from switching that went unexploited by domestic customers”. (para 112) It claims that this “provides evidence of weak customer engagement in the domestic retail markets for electricity and gas in Great Britain”. (para 117)
20. The CMA presents no evidence that customer engagement is weaker in the energy sector than in other sectors (or weaker in GB than in other countries). On the contrary, it acknowledges that “gains from switching are likely to be present in most markets”. (para 117)
21. So what does the CMA consider is different about the energy market? “117. ... we attach particular significance to the fact that they [gains from switching] are available at such levels to customers for domestic gas and electricity (which are homogenous goods and constitute a significant proportion of household expenditure).” So, the CMA’s reason for treating the energy sector differently is that the products are different. Energy products are “homogeneous goods” whereas other products are not.
22. We have argued at the beginning of this section above that this is a misleading argument and leads the CMA to predict behaviour that is inconsistent with observed experience. The CMA has concocted an argument that customers passing up gains from switching do so rationally in most markets, but irrationally in the energy market. However, it is readily apparent that in the energy sector, just as in other sectors, customers do not ignore differences in types of tariff, payment methods, customer interface, quality of service, previous experience, customer relationships and many other considerations. Customers do not look at gas and electricity as homogenous products, whereas the CMA believes they should do.
23. The CMA examines further the nature of the disengaged customers. “The survey results also suggest that those who are 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 against a variety of indicators of engagement.” (para 118) In effect, the CMA considers that these categories of customers are the worst offenders with respect to refusing to treat gas and electricity as homogenous products. They are the customers that the CMA considers to be acting most irrationally.

## **6. Trying to change customer behaviour ... and failing**

24. The CMA is thus led to argue that the problem in the energy market lies with customers. “However, in retail energy markets, competition requires a good level of customer engagement in order to be effective, in particular customers need to respond to price differentials by switching their custom to cheaper suppliers.” (NPR para 33) But the CMA considers that in the energy sector customers do not provide a good enough level of engagement for competition to work. Consequently, there is “an Adverse Effect on Competition through an overarching feature of weak customer response”. (SPF para 128)
25. How should this be dealt with? The CMA’s solution is to change customer behaviour. It proposes to nudge and prompt customers into behaving more

rationally (as the CMA sees it) in order to get the kind of competition that the CMA deems more appropriate or effective.

26. So, for example, the CMA proposes to “prompt customers who are on tariffs that they have not actively chosen to engage in the markets and make an informed choice regarding their next tariff”. (NPR para 88)
27. But prompts may not be sufficient. “Customers who are on tariffs that they have not actively chosen would receive ‘prompts’ to engage in the markets. We observe that previous interventions in retail energy markets appear to have had limited success in engaging inactive customers. Therefore, our current view is that any new remedies to prompt engagement may need to stretch beyond the provision of information in order to achieve their goal.” (NPR para 89)
28. This raises in the CMA’s mind the question whether customers should be moved to another tariff despite not having opted to do so: “Should customers who have failed to engage be informed that they are ‘no longer under contract for energy’, that they have been ‘rolled onto a safeguard tariff’...? (NPR para 90a)
29. The CMA then recognises that repeated prompts might annoy customers, hence poses the next question: “What should be the timing and frequency of prompts in order to balance effectiveness in terms of encouraging engagement with the cost and potential irritation that might arise from repeated prompts?” (NPR para 90c)
30. The CMA realises that some customers still might not behave as the CMA considers appropriate. It concludes that it has to take these customers’ decisions for them, and move them to another tariff. “For those customers who fail to respond to either the enabling measures set out in Remedies 3 to 9, or to the prompts set out in Remedy 10, our current view is that it is necessary to consider measures to prevent energy suppliers from rolling them on to relatively highly priced default or evergreen tariffs. Instead these customers would move on to a safeguard tariff.” (NPR para 91)
31. This safeguard or default tariff would no longer be set by the supplier. Customers would be forcibly transferred to it. And suppliers would no longer be allowed to offer the present standard variable tariffs. Even though these are the tariffs that about 70 per cent of domestic customers with the Six Large Energy Firms presently prefer. (SPF para 91) “Under this remedy, the maximum price level for default tariffs would be set by either the CMA or Ofgem. Customers who, in spite of the prompts provided, did not actively choose a new tariff at the end of their existing contract, would be rolled on to either a domestic or a microbusiness default tariff. No other evergreen tariffs would be permitted, including existing standard variable tariffs.” (NPR para 92)
32. This then leads the CMA to realise that there might be a problem about the level at which to set this safeguard tariff. “If it is set tightly, it will have a damaging impact on competition, undermining incentives for customers to engage in the markets. On the other hand, if set at too high a level, then at best it will provide no protection to customers, and at worst potentially provide a higher focal point for default prices to settle.” (NPR para 93)
33. Not surprisingly, the CMA also wonders whether this price control could have adverse consequences. “Could the imposition of a transitional safeguard price cap result in energy suppliers reducing the quality of service offered to customers on this tariff?” “Are there any potential unintended consequences of setting safeguard price caps?” (NPR paras 95 (c and m)) But these musings do not deter the CMA from proposing its price control.



## **7. Critique of the CMA analysis of competitive markets**

34. The CMA's proposed prohibition of Standard Variable Tariffs and reintroduction of price controls are a very significant change of regulatory policy – yet another significant change of policy in a sector that has already suffered so seriously from significant changes in regulatory policy. And they constitute a change in such a misguided direction. In terms of regulatory intervention they are even worse than Ofgem's post-2008 policies that the CMA has rightly found to have had an adverse effect on competition. And the CMA's proposal to reintroduce price controls is a policy that Ofgem itself has consistently and rightly rejected. We therefore need to explain our concerns at some length.
35. The usual defence of competition is that it tends to provide what customers want. In the case of the energy sector the CMA argues that most customers want the wrong thing. They have not yet learned how to behave properly in the market. They don't act the way they should act. So they should be prompted to act differently, to act the way the CMA considers they would act in a "well-functioning market".
36. As explained above, this hypothetical concept of a "well-functioning market" is inappropriate for determining policy, certainly a policy as interventionist and anti-competitive as price control. The CMA's approach is particularly disappointing since it had made a commitment to use a realistic assessment of market outcomes as a benchmark rather than an idealised notion of a perfect market.
37. Compared to real-world competitive retail energy markets, such as in Victoria, NSW, South Australia, Texas, Alberta, Norway, Sweden and elsewhere, the GB energy market until 2008 was right at the top. The present GB energy market, albeit restricted, is also comparable with the most competitive markets in terms of numbers of tariffs and customer engagement. The CMA's concept of a "well-functioning" market with some radically greater – but unspecified - level of customer engagement is an ideal that is not obviously realistic. The claim that "in retail energy markets, competition requires a good level of customer engagement in order to be effective", and that customer engagement is inadequate in the GB market, is out of touch with the reality of competitive retail energy markets around the world.
38. We are concerned that the CMA puts its own preferences as to how customers should behave over the preferences of customers themselves. The CMA is in effect advocating and taking steps to bring about a change of customer lifestyle. We are also concerned that the CMA gives undue priority to one aspect of a competitive market – the constant search for better alternatives – over another aspect – the building of successful and lasting customer relationships. Both aspects are important for customers. Is it the role of the CMA to distort the market in one direction rather than another, to prioritise price over customer loyalty, to promote instability rather than stability?
39. This is not to say that nothing could be done to further facilitate retail competition. We see merit in drawing customers' attention to the possibility of switching supplier or tariff type. We see merit in some of the actions the CMA proposes to remove or reduce barriers to customer engagement and switching, for example with respect to the rollout of smart meters, the arrangements surrounding teleswitch meters, access to customer data by PCWs, parity on inspection of gas meters, and so on.
40. But should the CMA really be considering prompts to customers that could inconvenience them because they don't share the CMA's views on what they

should do? It is an indication of the CMA's obsessive thinking that it seriously considers the possibility of disconnecting customers who have not chosen to move from a standard variable tariff to a fixed period tariff, before deciding that "the costs to customers in terms of the inconvenience that would result from disconnection would be very great". (NPR para 91 fn 23)

## **8. The adverse consequences of price controls**

41. The proposed safeguard or default tariff has serious disadvantages. As noted, the CMA recognises that "If it is set tightly, it will have a damaging impact on competition, undermining incentives for customers to engage in the markets." But it would be false to assume that if it is set at a more moderate level this will not have an adverse effect on competition. On the contrary, *any* enforced reduction in present tariffs will make a rival supplier's offerings less attractive. It will thereby reduce the ability of new entrants to compete and reduce the incentives for customers to engage. It will send the message that customers are henceforth to be protected by regulation, not by competition or their own action.
42. Thus, reintroducing price controls will not merely protect customers while the CMA's other remedies take effect and these customers gradually become more engaged. Rather, by actively restricting the growth of competition it will militate against the working of these other remedies, and defer the day when (in the CMA's view) customers are fit to be allowed to engage in the market unsupervised.
43. Reintroducing price controls will also significantly increase regulatory uncertainty, hence the cost of capital. Customers will pay for this higher cost.
44. The proposal ignores the practical and political considerations associated with price controls. There is no simple – or even complex - way to determine a "right level". There will be great pressure to set and reset the price control toughly, to demonstrate that it is of benefit to customers. The existence of prices in the market lower than the default price will be taken as a sign that the regulator has not been tough enough. There will be pressure to continue and tighten the control, little or no pressure to remove it.
45. As former energy regulators, we have had personal experience of introducing, monitoring and resetting price controls, and removing them as competition was introduced. Initially, no one knew how effective competition would be. The resetting of the price controls was problematic but we had no doubt that competition would flourish more effectively in their absence. Their removal was strongly criticised in some quarters, even though this was at a time when energy bills had been steadily falling (in real terms) for two decades, competition enjoyed strong all-party support and the regulator had a relatively strong statutory duty to promote it. In present different conditions, when energy bills have been rising, competition is questioned and Ofgem has a duty to look for regulatory solutions before promoting competition, we believe that a price control, once reintroduced, would be extremely difficult to remove, despite the CMA's intention that it be transitional.

## **9. Experience of price controls in New South Wales**

46. In proposing a safeguard price cap with a headroom above cost, the CMA says, "Such an approach has been used in New South Wales in Australia, and we are currently reviewing that example, both in terms of the approach used and the impact on the market." (NPR para 94) The situation in NSW is quite different from that in

GB insofar as the price control with a headroom above cost, followed by a transitional (two year) tariff, was used in NSW as a way of *removing* price controls, not as a means of *reintroducing* price controls in an already competitive and unregulated market. However, the important message is that the NSW regulator has clearly advised *against* price controls.

47. To explain, the domestic retail energy market in NSW was opened to competition in 2002. Until recently, the Independent Pricing and Regulatory Tribunal (IPART) set regulated prices. At first these were severe, and retail competition did not emerge at anything like the rate that it did in Victoria and South Australia. Later, IPART deliberately set regulated prices higher than estimated efficient prices. In its determination of prices from 2010 to 2013, IPART did this by setting the energy purchase cost equal to the estimated Long Run Marginal Cost (LRMC) (which was higher than market-based costs) and also included in the regulated price an estimate of costs to acquire customers. In its 2013-2016 determination (which in the event was in place for only one year), IPART continued to include customer acquisition and retention costs, ensuring that there was a margin above what it considered efficient costs (including an appropriate return) to allow market offers to be discounted against the regulated price. One consequence of this was that customers who remained on the regulated price were paying more than the efficient cost. However, IPART considered that encouraging the development of the market would induce longer-term dynamic efficiency.
48. In October 2012 the Australian Energy Market Commission (AEMC) was asked to review the effectiveness of competition in NSW and to provide recommendations on removing price regulation. IPART expressed the view that price regulation was no longer necessary or appropriate.

“We consider that electricity and gas price regulation is no longer necessary in NSW given that the retail electricity and gas markets now protect customers against market power by offering more choices and better price and service outcomes.

We consider that the removal of retail price regulation is likely to:

- Improve customer engagement in the market by removing the confusion in relation to the difference between regulated and market prices
- Remove the risk that price regulation distorts the competitive market, particularly given the dynamic nature of energy markets. This will encourage retailers in to the market and thereby deliver better customer outcomes in the long term, including better ‘value for money’ service through reduced costs and/or innovation.

Retail price regulation cannot protect customers from price increases driven by regulatory policy and market factors, nor can it protect vulnerable households that may be experiencing affordability problems. Rather, it is important to ensure that any specific groups of customer that cannot readily access the competitive market, or require financial assistance, are specifically considered and targeted responses are developed.” (IPART submission to AEMC Review, 2013 p 2)

49. The AEMC agreed with this view. “[w]e expect removing retail price regulation for all consumers will lead to more innovation, increased product choice, and competitive pricing. The Commission recommends a package of measures to

enhance consumer choice, including removing retail price regulation ...”<sup>1</sup> The NSW Government decided that the energy market should be deregulated and price controls removed as from 1 July 2014.

50. As part of this deregulation process, the NSW Government introduced a two-year ‘transitional tariff’ for domestic (household) customers.

“From 1 July 2014 any customers who had not switched over to a market contract were automatically transferred to a ‘transitional tariff’. For the vast majority of households on the transitional tariff arrangements, the tariff in the first year will be 1.5% lower than the regulated price they were paying. However, it should be noted that many market contracts may be much cheaper. The purpose of the transitional tariff is to serve as a safety net for regulated customers in their move to a market contract. At the end of the transitional tariff arrangements customer who have not already taken up a market contract will move onto their retailer’s default standing offer.”<sup>2</sup>

51. This 1.5% reduction was an outcome of negotiations between Government and retailers in the lead up to deregulation. However, it was not simply a bonus to customers or an acknowledgement that previous prices were too high: it reflected amongst other things the recent changes in network tariffs. Even if deregulation had not proceeded, the regulated tariffs would have changed anyway.
52. As part of the National Electricity Market, all retailers have to file a default standing offer, for supplying customers on a continuing basis until they choose to leave. These default standing offers are not subject to price control and the retailer may change them periodically. There is no provision – such as the CMA proposes – that retailers should be prohibited from offering the equivalent of evergreen standard variable tariffs of their own design.
53. The AEMC’s customer engagement research revealed that some small customers have chosen not to participate in the market. However, this was not seen as an impediment to removing price regulation. Further, IPART has taken the view that this is not a sign of a problem with the market, regarding it instead as a decision taken by the customers themselves.
54. In 2015 the AEMC expected that the removal of price controls in NSW would stimulate competition. “Further improvements in retail competition are expected in NSW, following the removal of price regulation in 2014. Retailers have suggested in surveys and interviews that there is increasing rivalry in NSW since the removal of regulation.”<sup>3</sup>
55. There are two important lessons from NSW experience. The first is that the price controls with headroom, followed by the recently introduced transitional tariff, were not a means of protecting customers in an already competitive market, as in GB. Rather, they were part of the process of *removing* price controls that had existed since the market was first opened. They were more like the transitional price caps that Offer/Ofgas/Ofgem employed at the time of market opening, in the late 1990s

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<sup>1</sup> AEMC, *Review of Competition in the Retail Electricity and Natural Gas Markets in NSW*, 3 October 2013, p i.

<sup>2</sup> NSW Government, Department of Industry, Resources & Energy, FAQs about electricity price deregulation, at [www.resourcesandenergy.nsw.gov.au](http://www.resourcesandenergy.nsw.gov.au) For household customers, “From 1 July 2015 the average price increase for these customers will be capped at the level of the Consumer Price Index.” These household customers would be transferred to the default standing offer on 1 July 2016.

<sup>3</sup> AEMC, *2015 Retail Competition Review: Final Report*, 30 June 2015, p iv

and early 2000s, as a transition *away* from the previous cost-reflective price controls.

56. Second, there is a very clear sense in NSW, as in other competitive retail markets in Australia, that price regulation is *not* the solution. It may seem to protect certain customers, but in doing so it restricts rivalry, innovation and improvements in retail competition, to the disadvantage of customers generally. The NSW regulator considered that the distinction between regulated and market prices confused customers and distorted the market. That is why regulators in competitive energy markets in Australia are strongly opposed to retail price controls.
57. Thus, experience in NSW provides no support for the proposed reintroduction of price controls in GB. On the contrary, NSW experience and policy clearly suggest that reintroducing price controls would be counter-productive.

## 10. The regulatory perspective in Australia generally

58. Since the CMA cites Australian thinking and practice as worthy of study, consider the views of the Australian Energy Market Commission, in its latest report just cited. The AEMC argues for the removal, not the introduction, of price controls. “To promote competition in retail markets and improve customer outcomes, the Commission recommends that jurisdictions ... remove energy retail price regulation where competition is effective.” (p 19)
59. Drawing on research by the International Energy Agency, the AEMC concludes that “maintaining price regulation is likely to cause more harm than good”. The IEA’s views are worth citing explicitly.

“Regulated prices can significantly delay the timely development of dynamic and innovative retail markets, with significant economic costs for consumers and the potential to substantially reduce effective customer choice and demand response. They can serve as policy-induced ‘focal points’ for standardisation of competitive behaviour, with the potential to induce tacit collusion in the market. Standardisation of prices, whether resulting from the actions of cartelists or regulators, has the potential to undermine new entry, reduce choice and discourage innovation. They can seriously distort supply-side incentives, which might also distort efficient and timely investment responses needed to ensure future reliability and affordability.”<sup>4</sup>

60. The AEMC endorses the view of competition as a rivalrous discovery process.<sup>5</sup> This is the view that the CMA and its predecessor bodies and the chairmen thereof have endorsed, but which is so markedly absent in the present *Provisional findings and Possible remedies*. The AEMC has a special feature on ‘Competition as an evolving process’ that gives numerous references to the economic literature. It concludes by explaining that “a market that exhibits effective competition may from

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<sup>4</sup> Cooke D, International Energy Agency, *Empowering Customer Choice in Electricity Markets*, Information Paper, October 2011, p29, as cited in AEMC *Review* p 19.

<sup>5</sup> “Markets are dynamic: conditions change as the cost of inputs and technologies change, demand levels vary, innovation occurs, firms enter and exit the market and customer preferences change. Markets provide the mechanism for retailers to discover what customers want and for customers to discover the price and service combinations that retailers are offering. Higher retailer returns can reward innovation and strong customer service, and also drive new entry which in turn creates further incentives for differentiation and cost reduction. This is a continuous, iterative process and one that does not always happen smoothly, but through the process of discovery and experimentation businesses adapt in order to meet the varying needs of customers.” (AEMC, *Review of Competition in the Retail Electricity and Natural Gas Markets in NSW*, 3 October 2013, p 19)

time to time see increased profits, a reduced number of firms or reduced customer satisfaction. Far from being a failure of competition, this may be a reflection of the evolving state of that market and the many factors underpinning its development.” (p 22) There is no recognition of this in the CMA’s present report.

61. The AEMC reports experiences that parallel those in the UK. It notes increased customer complaints in some respects. It found that those who had shopped around had generally found better deals and were more satisfied with their retailer. Customers remaining on standing offers, which were generally higher priced, were more likely to be older or living in rural areas. And so on. But the AEMC has not been panicked into restricting the number and types of tariffs, nor into reintroducing price controls. Instead, it recommends raising awareness of means of comparing energy offers, tailoring communications to different audiences, ensuring concession schemes are delivering on their intended purpose, improving the accuracy and timeliness of the customer transfer process, and removing price regulation where competition is effective, as in Victoria, South Australia and NSW. (pp iv-v) The CMA evidently has much to learn from Australia.

### **11. Alleged customer over-charging in GB**

62. The CMA looks at over-charging in the domestic retail sector. It says, “176. We have considered whether there is evidence that the overall average prices paid by customers of the Six Large Energy Firms have been higher over the past few years than they would have been under a well-functioning competitive market in which costs and profits are competed down to efficient levels. In a well-functioning competitive market we would generally expect to see returns broadly in line with the cost of capital over the long term.”
63. This is another example of where the CMA is led astray by the concept of a “well-functioning market”. The sentences quoted describe a hypothetical market in long-run equilibrium, with prices equal to efficient costs and a return broadly equal to the cost of capital. This is not at all the model of competition as a rivalrous process taking place over time which has traditionally been espoused by the CMA, and the Competition Commission before it.
64. In the real world, by contrast with the CMA’s “well-functioning” market”, profits vary over time as some companies succeed and others fail, some companies manage to reduce their costs faster than others. The CMA indeed reports such variation in profits in the energy market, and says that some companies made losses.
65. The CMA reports that “some firms may not have operated efficiently”. (para 180) But in reality, there is no such thing as what it calls “the efficient level” of costs, only the level that the lowest cost company has managed to achieve at one point in time. Most firms will not have the same level of costs as the lowest cost firm: that is a reflection of reality, not a sign of lack of efficiency or competition.
66. The CMA calculates that the Six Large Energy Firms earned an average return on capital of 28% over the five years 2009 to 2013, whereas their cost of capital was around 10%, hence they earned profits in excess of the cost of capital of about £900m per year. (para 178)
67. The CMA then observes that there were differences between the six companies with respect to costs and profits. Having “attempted to control for these differences in cost” (para 181) the CMA estimates that “average prices offered by the Six Large Energy Firms over the period 2009 to 2013 were around 5% above the competitive level in the domestic segment, and around 14% in the SME segment. This equates

- to domestic customers paying around £1.2 billion and SME customers paying around £0.5 billion more on an annual basis than would have been the case had competition functioned more effectively.” (para 181)
68. This seems to imply that, for domestic customers, profits in excess of the cost of capital amounted to about £900m per year, and inefficient costs on the part of some companies accounted for a further £300m per year, making a total cost to customers of about £1.2 bn per year.
  69. It is not only difficult to square the CMA’s theoretical concept of competition with that of competition in the real world, it is also difficult to see how its calculations can be squared with the net revenues that the suppliers actually earned over this period. The CMA reports that in Domestic Supply, total EBIT for the Six Large Energy Firms combined was £110m in 2007 and minus £6m in 2008.<sup>6</sup> Total EBIT then increased to an average £862m over the next five years 2009 to 2013. How can domestic customers have paid around £900m more than if the market had been more competitive? In a “well-functioning market” are firms supposed to operate at a loss?
  70. The CMA’s further adjustment to allow firms “to recover efficient levels of costs” means that their prices are considered excessive by a further £300m. The CMA does not explain how it does this calculation and what assumptions it makes. But it seems that the CMA is proposing to introduce a price control on the industry not only because firms are making excess profits (on the basis of its hypothetical calculations), but because some of these firms are not as efficient as others by £300m a year.
  71. Without further specification it is difficult to assess the CMA’s efficiency argument. In one of its working papers the CMA claimed that the lack of convergence of costs was a sign of lack of effective competition. In real-world competitive markets there is no necessary convergence of costs, though as it happens there has been a noticeable convergence of costs in this market.<sup>7</sup>
  72. Furthermore, there is a plausible reason for increases in and variation of costs in this market, insofar as government interventions have placed costly environmentally-related schemes on suppliers, and these requirements have changed frequently and unexpectedly. This is true elsewhere too. For example, in setting retail price controls in June 2013 the NSW regulator IPART assumed an increase of around 33% in real terms in the retail operating cost allowance going forward compared to the previous allowance for 2012/13. In addition, the cost of capital must have increased in recent years as investors seek protection against increases in regulatory and political risk.
  73. Given that the entire UK market economy is characterised by some firms being more or less efficient than others, the as-yet unsubstantiated allegation that some retailers are less efficient than others seems a remarkably cavalier basis for introducing a price control on the energy sector. On this basis the whole of the UK economy would presumably need a price control.

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<sup>6</sup> *CMA Provisional Findings*, Appendix 10.2 Retail Energy Supply Profit Margin Analysis, Table 5: Domestic supply profit ratios for the Six Large Energy Firms combined, posted 10 July 2015

<sup>7</sup> Stephen Littlechild, Operating cost variations in a competitive market, submission to CMA Energy market investigation, 20 February 2015.

## 12. The cause of increased profits and the implication for remedies

74. Having analysed profitability, the CMA provisionally concludes that average prices paid by domestic customers have been above the levels in a “well-functioning market”. It says that the preponderance of evidence “is suggestive of weak competitive conditions in the retail energy market. It is consistent with our provisional finding that suppliers have the incentives and ability to raise prices above costs to a significant segment of their customer bases who are disengaged or only periodically engaged in retail energy markets.” (para 190)
75. The implication is that the alleged excess profits are a result of the lack of customer engagement, which leads the CMA to focus on methods to increase that engagement. Surprisingly, there is no mention here of Ofgem’s policy interventions which the CMA finds “have changed the nature of competition significantly”. It says

Over the last six years, three major interventions by Ofgem have changed the nature of retail competition significantly:

(a) The prohibition on regional price discrimination introduced in 2009.

(b) The introduction of new licence requirements, standards of conduct and enforcement action resulting in the withdrawal of the Six Large Energy Firms from doorstep selling in 2011 and 2012

(c) The introduction of Retail Market Review (RMR) reforms in 2014 introduced a number of obligations on suppliers, including several provisions relating to tariffs, notably restricting the number of core tariffs. (para 87)

76. The CMA goes on to find that the first of these interventions softened competition, the second may also have had an impact, and the third constitutes an Adverse Effect on Competition. Yet when discussing the adverse effects of these regulatory restrictions the CMA shies away from any suggestion that they may have impacted on profitability.
77. Nevertheless, the association of profitability with these regulatory interventions seems stark. Before 2008 it was difficult to find any profits in the retail supply sector, let alone excess profits. For example, Ofgem’s net margin calculations showed a positive net margin on dual fuel customer bills in only three brief periods between August 2004 and August 2009, yet after 2009 this net margin was always positive.
78. Consider, too, the EBIT figures just mentioned above: the CMA reports that in Domestic Supply, total EBIT for the Six Large Energy Firms combined was £110m in 2007 and minus £6m in 2008.<sup>8</sup> Total EBIT then increased to £379m in 2009, to an average of £785m over the next two years then to an average of £1180 in 2012 – 2013. It seems very likely that regulatory restrictions on competition were an important reason for the increase in profitability. (Note that although Ofgem’s RMR ‘simpler tariff’ restrictions were fully and formally implemented in 2014, Ofgem had proposed these restrictions in 2012 and the suppliers had largely implemented them by 2013.)
79. This association between Ofgem’s policy interventions and profitability has a very significant implication for remedies. The CMA’s recommendation to reintroduce price controls some 13 years since they were lifted results from the CMA’s

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<sup>8</sup> *CMA Provisional Findings*, Appendix 10.2 Retail Energy Supply Profit Margin Analysis, Table 5: Domestic supply profit ratios for the Six Large Energy Firms combined, posted 10 July 2015



calculation that suppliers have been over-charging customers by over £1bn per year. But to the extent that the increase in profits from the low level before 2008 was attributable to the policy interventions that restricted competition, then removing those interventions as the CMA recommends will address the cause of those increased profits. This would render price control unnecessary as well as undesirable.

80. Just as Ofgem's interventions had an impact on overall retail profits, they also had an impact on relative prices of different types of product and on the nature of competition. For example, the CMA is concerned about the increased price gap between SVTs and fixed price tariffs. But this too has been induced by the RMR interventions, which make it very difficult to compete on SVTs and drive competition into fixed price tariffs.<sup>9</sup> Removing this RMR restriction could be expected to address the relative price issue too.
81. Part of the CMA's argument for reintroducing price controls is that its other remedies "however well designed and implemented, will take time to deliver the benefits of competition to those customers who are disengaged". (NPR para 85) But there is no reason to believe that suppliers would be reluctant to take advantage of the opportunity to bring back tried, tested and popular tariffs that have been banned since 2009, together with new ones that were either prohibited by the RMR regulations or simply in excess of the number of tariffs allowed. Many of the suppliers have given damning evidence of how the RMR regulations have restricted them.<sup>10</sup>
82. In addition, there is now a very vibrant fringe of new suppliers, all with innovative products and/or offers. The CMA's guidelines state that entry or expansion may upset established patterns of market conduct or introduce new technology and fresh approaches to product design, marketing and delivery. The entrants in the domestic retail energy market have been characterised by lower cost bases (eg new IT systems), different product design (eg paying interest on credit balances and new smart prepayment meters), innovative marketing (eg more personal contact) and new forms of delivery (eg smart meters included). The CMA has given remarkably little attention to the impact of these entrants. They can be expected to add to the competitive pressure on the six large suppliers, and increasingly to direct their attention to attracting precisely the high-margin customers that are the CMA's particular concern.
83. Ofgem and therefore the CMA have a duty to have particular regard to the situation of vulnerable customers rather than of customers who do not choose actively to engage in the market. In assessing the case for reintroducing price controls while its other remedial measures take effect, it is not clear that the CMA has given sufficient regard to the existing provisions for support, and to the ever-increasing number and range of developments, associated with suppliers, PCWs, TPIs, local, regional and national governments, that seek to improve the situation of vulnerable customers in the modern competitive energy market.

### **13. Price differentiation and fair tariffs**

84. In our February 2015 submission we noted that Ofgem's non-discrimination condition SLC 25A was designed "to remove more than £500 million in unfair

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<sup>9</sup> Stephen Littlechild, Gap between Standard Variable Tariffs and Fixed Tariffs: the impact of RMR, Submission to the CMA, 25 June 2015.

<sup>10</sup> CMA, *Appendix 8.2: Impact of the Retail Market Review*, paras 44-48, 63-68

premiums from suppliers' tariffs". Ofgem envisaged that, in responding to the new licence condition, suppliers would increase other prices to maintain their net income. So Ofgem appeared to be engaging in a policy of redistributing income to increase "fairness". We expressed concern about the nature, impact and statutory basis of this policy, and urged the CMA to investigate whether it was still in place and whether it should remain.

85. The CMA now introduces discussion of the non-discrimination condition as follows. "147. In 2009, Ofgem implemented SLC 25A, in an attempt to address concerns that certain groups of customers were not benefiting from competition. The prohibition lapsed in 2012. However, suppliers told us that, following a communication from Ofgem warning against 'pricing practices which are unjustified [...] returning to the market', they continued to adhere to the principles of SLC 25A in their pricing of SVTs. In December 2014, Ofgem wrote to suppliers to confirm that SLC25A had lapsed and that suppliers were not bound by it in any way."
86. The CMA notes that there was an apparent softening of competition from 2009 onwards. It concludes, "150. Overall, we think it is likely, on the basis of the evidence that we have seen, that SLC 25A contributed to a softening of competition on the SVT, although other factors may also have had an impact. However, since Ofgem has confirmed that this licence condition is no longer in place, we do not consider that it currently leads to an AEC."
87. We welcome the CMA's confirmation that the non-discrimination condition softened competition, insofar as this helps to explain the increase in profits from 2009 onwards and provides guidance as to how not to regulate in future. However, in our view, the CMA's dismissal of the present possibility of an AEC does not deal adequately with this issue. Moreover, the CMA's own position is ambiguous and potentially concerning.
88. As mentioned, Ofgem stated in 2014 that since SLC 25A had lapsed suppliers were not bound by it in any way. But Ofgem had previously issued a separate warning against "pricing practices which are unjustified ... returning to the market". Does that warning still apply? If so, what pricing practices are to be regarded as justified and what are unjustified? Ofgem has never formally withdrawn that warning. It is therefore understandable that suppliers act on the basis that they are still bound by it. The CMA's dismissal avoids rather than clarifies the situation.
89. Ofgem's present policy emphasises that suppliers have to treat customers fairly. The notion that this applies to everything but prices will probably be a surprise to many people, but in fact the Standards of Conduct explicitly exempt prices from this obligation. Ofgem made this point in its hearing before the CMA (31 March 2015). "It was not seeking to mandate fair tariffs in the market but it did have rules for fair behaviour of suppliers under its Standards of conduct rule. The concept of fairness and the Standards of conduct applied to the conduct of suppliers as opposed to their pricing strategies."
90. The implication seems to be that Ofgem no longer requires suppliers to be bound by its warning statement on "pricing practices which are unjustified" because it no longer presumes to judge whether prices are justified or otherwise. By further implication, it no longer considers that price differentials have to reflect cost differentials. It would be helpful if Ofgem could issue and commit to this welcome clarification. It would provide some reduction in regulatory uncertainty, and also suggest a better understanding of pricing practices in competitive markets.

91. The CMA explicitly says that one of the remedies it is minded not to consider further is Remedy e: introduction of price non-discrimination conditions. (NPR para 148) It explains why non-discrimination conditions would not facilitate the longer-term development of competition in the market, and indeed would reduce competitive pressure. Encouragingly, this hints at some appreciation that actual competitive markets are characterised by a great deal of price differentiation.
92. However, there may be a problem insofar as the CMA's main document seems to rely on the concept of non-discrimination in order to find the Six Large Energy firms guilty of exercising market power. It says, "133. Overall, our provisional view is that the Six Large Energy Firms enjoy a position of unilateral market power over their inactive customer base and have the ability to exploit such a position *through pricing their SVTs materially above a level that can be justified by cost differences from their non-standard tariffs.*" Continuing, the CMA finds that suppliers have unilateral market power concerning their inactive customer base, and "135. ... suppliers have the ability to exploit such a position through their pricing policies: *through price discrimination by pricing their SVTs materially above a level that can be justified by cost differences from their non-standard tariffs;...*". (italics added in both cases)
93. Does this mean that only price differentials that reflect cost differentials are acceptable? That would be inconsistent with the widespread price differentiation that obtains in all competitive markets, with Ofgem's present position, with the CMA's finding that the previous non-discrimination condition softened competition, and with the CMA's position in its *Notice of Provisional Remedies*. The CMA needs to clarify its position here.

#### **14. An Ofgem Price Comparison Website**

94. The CMA's remedy 6 is that Ofgem should provide an independent price comparison service for domestic (and microbusiness) customers. "The rationale for setting up an independent price comparison service with all available tariffs listed is to allow domestic customers who have concerns about the quotes they receive on other PCWs to use this service to check the tariffs that they have been quoted elsewhere. Therefore, the aim of this remedy is to increase customers' trust in the services offered by PCWs, encouraging engagement and switching." (NPR para 68)
95. This is implausible. The very setting up and advertising of such a site would announce to customers that Ofgem regards the service provided by PCWs as untrustworthy. The proposal would reduce customers' trust, not increase it.
96. The CMA explains that "PCWs are an important means by which effective competition can develop in the domestic retail markets". (NPR para 68) We agree. If there were no such price comparison websites in the UK things might be different. But the UK seems to have more, and more effective and innovative, price comparison sites covering the energy sector than any other country in the world. This seems to be an extremely competitive and successful market.
97. How then can one justify introducing yet another site run by the regulator and presumably paid for by a levy on suppliers and hence on customers? This in itself could be anticompetitive: indeed, the CMA asks whether this service could undermine the development of other PCWs. What is it supposed to provide that other sites do not? There has been no suggestion that other sites do not accurately list the offers of suppliers, and many sites are now claiming to list all the offers available.

98. The CMA seems to consider that a regulatory website would be more authoritative than other websites. In practice, however, sites run by regulators often have difficulty in funding the kind of service that customers want. Nowadays, a successful, accurate, up-to-date, flexible and customer-friendly comparison website is an expensive proposition. The CMA has acknowledged that it may well not be practicable for any website to list all offers in the foreseeable future. The notion that a regulatory website can provide an authoritative picture is illusory.
99. In order to make the situation manageable, some regulatory websites list only offers of a prescribed form, and rank the offers according to the cost at a specified consumption level. This makes it possible for a supplier to “game” such a regulatory website. For example, in some US states a supplier will offer discounts and surcharges for over- and under-consumption relative to the specified consumption level. In this way its offer is ranked cheapest but may only be cheapest for a very narrow consumption band.
100. The presence of a variety of PCWs in the market, each using its preferred method to evaluate tariff offers and to advise customers, is the more effective way to protect customers and encourage them to engage. Moreover, the most effective appeals to customers to engage in the market will result not from further regulation, but from the actions of rival suppliers and PCWs. They have by far the most experience in this matter, the most resources to explore the options and invent better ways to encourage customer engagement, and an obvious financial interest in succeeding.
101. At the time of domestic market opening around 1998, regulators Ofgas, Offer and Ofgem made conscious decisions not to operate a comparison website, but at the same time encouraged other parties to do so. That has been the firm position of Ofgem ever since, it has proved successful, and we believe it is the right one. Nothing the CMA has said suggests that it was inappropriate and should be reversed. The CMA has made no credible case for Ofgem operating such a price comparison website.

### **15. Vulnerable customers and face-to-face marketing**

102. In our previous submissions we have urged the CMA to consider how best to assist vulnerable customers. The CMA has rightly drawn attention to the adverse effects of RMR regulations on these customers.<sup>11</sup> So we are pleased that the removal of the ‘simpler choices’ component of RMR will once again enable suppliers to offer tariffs like Staywarm, and tariffs with no standing charge, that many vulnerable customers like.
103. We also saw “an important role for regulation in better facilitating access of vulnerable customers to the benefits of a competitive market, rather than limiting the ability of the competitive market to provide those benefits in the first place”. As smart meters and other communications technologies develop in future, restrictions that hark back to a simpler era will be increasingly inappropriate as a means of stimulating customer engagement, new entry and innovation. We note that the CMA is exploring the possible contributions of smart meters to assisting vulnerable customers.

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<sup>11</sup> CMA, *Appendix 8.2: Impact of the Retail Market Review*, para 45

104. However, some vulnerable customers may have difficulty with changing technology. They will need more personal contact, advice and assurance. This raises the question of face-to-face marketing.
105. Ofgem and others had concerns about an early manifestation of personal contact, viz door-to-door selling, which was characterised by considerable mis-selling. Ofgem modified its Standards of Conduct to deal with this, and enforced the “marketing condition” rather strictly. Partly as a result of this, all the major suppliers ceased doorstep selling.
106. The CMA now says, “We have not received any submissions raising concerns regarding the impact of Ofgem’s rules on doorstep selling. We recognise the importance of customers being provided with clear and accurate information in order to make informed choices regarding their energy tariffs. Therefore, we are not currently minded to consider remedies that would relax Ofgem’s required standards of conduct in relation to doorstep sales.” (NPR fn 12)
107. We appreciate the problems that some doorstep selling caused. However, there are at least two problems with the CMA’s proposed stance. The first is that the combination of the non-discrimination condition and the cessation of doorstep selling literally halved the extent of customer switching (from about 20% to 10% of customers per year), the CMA finds that competition has also been softened, and reports a significant increase in supplier profits. (Appendix 10.2 referenced above)
108. Which determining factor was most important is debateable. If it was the non-discrimination condition, and later the RMR ‘simpler choices’ restrictions, then the CMA’s proposal to remove these restrictions ought to yield a significant increase in engagement, with a consequent increase in competition. This undermines the CMA’s argument for reintroducing a price control. But if the cessation of doorstep selling was a significant factor, then the CMA is declining to consider remedies associated with the cause of an adverse effect on competition that the CMA deems so serious as to require price controls to deal with it.
109. The second and related problem is that doorstep selling was a particularly effective way of reaching certain categories of vulnerable customers. They now engage less than they used to engage: the marketing rules have hit them hardest. Quite apart from doorstep selling in the traditional sense, the rules are also hampering the ability of suppliers and PCWs to engage in other forms of face-to-face marketing. This in turn seems to be preventing a greater role for Third Party Intermediaries (TPIs) in advising customers, particularly vulnerable customers.
110. It has elsewhere been argued that the marketing condition needs to be revised to reflect previous experience and changing circumstances.

“ ... much has happened since 2008 that needs to be taken into account – including expanded consumer protection legislation, experience with the new licence condition, evolving public opinion, changing shopping habits including online, greater use of price comparison websites, new technologies, the Energy Ombudsman, collective switching, smart metering, etc. The basic problem seems to be that present regulation has gone beyond customer preferences and concerns, and taken insufficient account of the practicalities of supplier delivery. The question is how best to accommodate and reconcile all these considerations in a revised marketing condition. Given the time and information limitations, this could best be achieved by the CMA encouraging a customer engagement process. Customer representative groups, suppliers, TPIs including comparison and switching sites, Citizens Advice, Trading Standards Institute and other interested parties could be invited to discuss this issue with a view to

proposing an agreed recommended marketing licence condition for consideration by the CMA.”<sup>12</sup>

111. We consider that it will be important to enable new ways of engaging face-to-face with vulnerable customers, and enabling them to engage with the market, and that this will require something more than technological solutions alone. We also note again that Ofgem has a statutory remit with respect to specified sets of vulnerable customers. It is therefore important to focus attention and remedial measures on those customers, rather than on the much larger set of customers who continue to choose to purchase energy on a standard variable tariff.

## **16. Implementation of remedies**

112. In framing and implementing any remedies the CMA will need to consider carefully how they are designed and implemented and who introduces them. The CMA has found that Ofgem’s main interventions in the domestic retail market over the last seven years have softened competition and constitute an Adverse Effect on Competition. Ofgem was repeatedly warned of this before their introduction and as their effects unfolded, but continued to introduce new measures of the same kind over that whole period. This is a serious indictment.
113. We would therefore urge the CMA in framing any remedies to make maximum use of trials of any significant remedies before implementing them. More generally any remedies embedded in licences should have clear sunset clauses so that they automatically expire after a specified period of years, perhaps two years in the first instance. This will provide an important safeguard insofar as Ofgem would then have to make the case to continue that remedy. And it would allow suppliers or others to refer the matter back to the CMA if it appeared that the remedy was having an adverse effect.

## **17. Conclusion**

114. We support many of the CMA’s preliminary findings, especially the diagnosis that important components of the energy sector do not constitute adverse effects on competition, the confirmation that regulatory interventions have restricted competition in the domestic energy market, and the recommendation to remove those restrictive regulations so as to promote competition. However, we are very concerned about some of the CMA’s analysis and, in particular, about the CMA’s proposals for further regulatory interventions, specifically, its recommendation to reintroduce price controls into that market.
115. Since the CMA has found that regulatory interventions have softened and had an adverse effect on competition, it is not surprising that supplier profits have risen since 2008, and that they are higher than they would have been in the absence of these regulatory restrictions. But have profits really been excessive, won’t removing the offending regulatory interventions address the problem, and if profits are excessive is reintroducing a price control the most appropriate way to address them? It is worth looking in more detail at each of these questions.
116. Consider the number and significance of the assumptions necessarily embodied in any calculation of excess costs and profits, the relatively dubious nature of the

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<sup>12</sup> Stephen Littlechild, The regulation of energy marketing including doorstep selling, Submission to CMA Energy market investigation, 11 January 2015.

CMA's calculations and the lack of substantiating detail that it provides, the sensitivity of the CMA's calculations to the inclusion or exclusion of particular suppliers and years, and the magnitude (5%) of the alleged over-charging (which is calculated relative to some hypothetical and unrealistic long-run equilibrium position and necessarily subject to a margin of error) in contrast to the wide range of returns observed in practice and allowed by different regulators. Can one really be confident that customers have been significantly overcharged?

117. Consider, next, the CMA's recommendation to remove the 'simpler choices' RMR restrictions. It rightly expects this will stimulate competition. This can be expected to drive down prices and profits and put increasing pressure on the larger suppliers to cut unnecessary costs and increase efficiency, and moreover to enable suppliers and PCWs more effectively to stimulate the engagement of customers – in other words, to address precisely the problems that the CMA perceives in this market. Can one really be so confident that removing the present harmful regulatory intervention will not address those problems as to make it necessary to reintroduce price control?
118. Consider, finally, the CMA's primary statutory duty to seek to promote competition for the benefit of consumers, plus the CMA's own mission "to make markets work well". There is absolutely no doubt that reintroducing price controls will make competition less effective, not more effective. Can one really be confident that the net effect of the CMA's proposals will promote competition for the benefit of consumers and make the domestic market work well? And that reintroducing price controls is a necessary component of that policy?
119. Putting all these considerations together, is it really a plausible and proportionate recommendation to reintroduce price controls on the domestic retail energy market, when that energy market, before Ofgem's change of policy in 2008, was the most competitive domestic retail energy market in the world?