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Dear Will

Response by former GB energy regulators to CMA Provisional Decision on Remedies

Overview of our main concerns

1. The CMA's *Provisional Decision on Remedies*¹ confirms that it is moving to a well-considered resolution of a large number of the issues raised in its energy market investigation, particularly those related to the wholesale market. Unfortunately, however, in our opinion there still remain serious flaws in its analysis of the domestic retail market. These are associated with its concept of "weak customer response", its calculation of excess charges and excess profits, its assumption about "efficient costs", and its failure to analyse the full impact of previous regulatory interventions. These flaws lead the CMA to some inappropriate remedies. Moreover, this flawed analysis has serious implications for the future work of the CMA with respect to markets generally.
2. The finding of alleged "weak customer response" overrules customer preferences and switching costs. It is defended by claiming that savings available but not exploited by customers average £164 per year. This relies on the unrealistic assumption that all customers would be happy to switch to online direct debit fixed-period tariffs. Realistic assumptions that respect customer preferences yield much smaller savings available (average £65 per year), consistent with normal customer behaviour in a competitive market.
3. The CMA's "direct approach" claims that the Six Large Energy Suppliers (SLEFs) have imposed excessive charges on customers averaging £1.7bn per year from 2012 to 2015, rising to £2.5bn in 2015. How this can be reconciled with aggregate SLEF profits of about £1bn per year, or with the CMA's calculation of much lower "excess profits", is never satisfactorily explained. The calculation is based on a dubious comparison with the prices charged by two much smaller new entrants that ignores many relevant considerations. It is more than £1bn per year greater than the estimate yielded by the CMA's alternative "indirect approach", which is itself based on implausible assumptions. Neither approach yields a credible measure of customer detriment.

¹ *Energy Market Investigation, Provisional Decision on Remedies*, CMA, 17 March 2016. Unless otherwise indicated, all quotations and paragraph numbers refer to this document.

4. The CMA's claim that the SLEFs have earned excessive profits of £241m per year over 2007 - 2014 is based on another dubious calculation. Instead of using their actual costs and capital, it uses lower costs and capital assumed to be needed by a hypothetical capital-light firm. Even thus inflated, excess profit amounts to less than £5 per year for each energy account, or less than 1 per cent of an average dual fuel bill of nearly £1200 per year.
5. The CMA calculates that four of the SLEFs have inefficient indirect costs of up to £420m per year in total compared to the other two SLEFs. But cost differences are not a sign of market power in real competitive markets, which do not require three quarters of total output to be produced at the same level of cost. The Competition Commission never relied on such a contentious argument.
6. The CMA finds that Ofgem's various regulatory interventions since 2009 have adversely affected competition but it fails to consider their market-distorting effects on customer engagement, price differentials and profits. Hence it underestimates the beneficial effects of removing them and overestimates the need for further remedies.
7. As to proposed remedies, the CMA does not explain why the serious adverse effects that it correctly assumes would be caused by a price cap on Standard Variable Tariffs (SVTs) would not equally accompany a price cap on Prepayment Meter (PPM) tariffs. It does not consider the likelihood that suppliers would react by increasing prices to other customers, and does not attach weight to the overwhelming adverse financial impact on the one small supplier that has specialised in providing innovative service to PPM customers.
8. The proposals that suppliers should be required to hand over data concerning their "disengaged" customers and should have a new "tariff comparability" obligation do not sufficiently take into account customer preferences, practical implications and lessons of recent regulatory history. Like the proposed price control, they run counter to the Government's latest "Steer".
9. The CMA's failure to examine the adverse consequences of the direct marketing licence conditions means that it has not considered a remedy that could enable more and better engagement, including with Third Party Intermediaries (TPIs) and with vulnerable customers.
10. The CMA's analysis is thus seriously inaccurate and incomplete. It does not provide a proper understanding of the domestic retail energy market, nor a sound basis for further regulatory interventions. On the contrary, rather than seeking the most considered, responsible and defensible analysis of the market, the CMA seems to have sought out assumptions and interpretations to maximise the extent of customer detriment. This is not the stance taken by the former Competition Commission (CC), and will not increase trust in the CMA.
11. If this approach were applied to other markets, the potential for finding weak customer response and excessive prices, costs and profits would be enormous. The CMA's energy market recipe is not to let the competitive market process work but to intervene to impose what it thinks would or should be the outcome if the market were "well-functioning" and almost all competitors had "efficient costs". The logic of this argument would imply intervention in every market

where new entrants were challenging incumbents – that is, in every market that was not in or near a state of perfect competitive equilibrium. This does not seem a sensible direction for UK competition policy.

12. Our response is in six sections.

- Section One sets out our views on the CMA's provisional findings and remedies.
- Section Two explains in more detail why we believe that the CMA's analysis provides a misleading – inaccurate and incomplete - picture of the domestic retail energy market.
- Section Three examines in more detail the provisional remedies for the Adverse Effect on Competition (AEC) associated with the Retail Market Review (RMR).
- Section Four examines in more detail the provisional remedies for the AEC associated with weak customer response.
- Section Five looks at price controls for PrePayment Meter (PPM) customers.
- Section Six traces the broader implications of the CMA's approach for the work of the CMA in markets generally.

Section One: Our views on the CMA's provisional remedies

i) Wholesale electricity market remedies

13. As explained in our previous submission of 16 July 2015, we welcome the CMA's provisional findings that most aspects of the electricity and gas wholesale markets are working well. The CMA found that two aspects of the regulatory regime governing the wholesale electricity market operation led to AECs, namely a) the mechanisms for allocating Contracts for Differences for renewable energy and b) the absence of locational charging for transmission losses. We support the CMA's provisional remedies for these AECs.

ii) Updated assessment of detriments affecting customers

14. The CMA claims that there is "weak customer response" because customers pass up the opportunity to save an average of £164 per year on an average dual fuel bill. This figure is based on the CMA's unrealistic scenario 5x, which ignores customer preferences for tariff types. Its more realistic scenario 3b gives an average saving of £65 per year, which is consistent with normal customer behaviour in a competitive market.

15. The CMA uses two approaches, described as "direct" and "indirect", to measure customer detriment. The CMA's "direct approach", which it describes as its preferred approach, finds that prices charged by the Six Large Energy Firms (SLEFs) to domestic customers exceeded those charged by the "most competitive" suppliers by an average of £1.7bn per year over 2012 – 2015, increasing to £2.5bn in 2015. This calculation ignores customer preferences as between suppliers and tariff types. It also takes no account of particular circumstances affecting the two Mid-tier "most competitive" suppliers against which the CMA measured the "excess charging" of the SLEFs. These Mid-tier suppliers were largely exempt from certain significant social and environmental costs for much of the period of comparison, and only one was profitable in 2014.

16. The conventional competition authority approach to estimating detriment is to calculate excess profits. The CMA calculates that SLEF excessive profits from domestic customers averaged £241m per year over 2007 – 2014. The assumptions underlying this calculation are questionable, but even so this is only about one seventh of the claimed £1.7bn excessive prices.
17. The CMA also calculates that "inefficient costs" of the SLEFs in the domestic market averaged £290m per year over the same period, or £420m if the more efficient suppliers are excluded. This artificial calculation – not conventionally used by the Competition Commission or other competition authorities - measures the market against an unrealistic equilibrium benchmark where three quarters of all firms (by output) are equally efficient.
18. The CMA's "indirect approach" measures customer detriment as the sum of these last two items, viz £241m + £420m = £661m per year. The fact that the indirect approach (itself artificially inflated) yields a total of £661m, around £1bn to £1.8bn less than the alleged £1.7bn and £2.5bn excessive price calculations, is further indication that the latter are exaggerated. We discuss these matters further in Section Two.

iii) Creating a framework for effective competition - Removal of simple tariff restrictions

19. We strongly agree with the CMA's provisional finding that the 'simpler choices component' of the RMR rules has had adverse effects on the ability and incentives of suppliers to compete on the range of tariffs and discounts offered to domestic customers. And that it also limits the scope for competition between Price Comparison Websites (PCWs) to exert downward pressure on energy prices.
20. We therefore welcome the CMA's provisional remedy to remove various "simple tariff" restrictions introduced as part of Ofgem's RMR policy. We consider that the CMA is right to extend the list of restrictions to be removed, compared to that set out in its *Possible Remedies*. Indeed, we suggest in Section Three below that yet more such restrictions could usefully be removed.
21. Furthermore, we suggest that Ofgem's introduction of these restrictions has been responsible for some of the phenomena that the CMA mis-diagnoses as "weak customer response" and for some or all of any calculated excess profit. Removing these restrictions will therefore have a more beneficial effect on competition than the CMA has allowed for, thereby reducing or removing the need for other remedies.

iv) Reform of the settlement systems for gas and electricity

22. The CMA has found that elements of the settlement systems of both gas and electricity lead to inaccuracies and delays that distort competition between energy suppliers. These elements include the absence of a plan for moving to half hourly settlement in the domestic Electricity and Gas markets. We support the remedies that the CMA has proposed for these AECs.

v) *Addressing technical and regulatory constraints impeding competition for PPM customers*

23. The CMA has found features on the supply side of the market that constitute a Prepayment AEC. We are sympathetic to remedying the constraints imposed by the dumb prepayment infrastructure that the CMA identifies as impeding competition. We support the remedies designed to make better use of the available tariffs slots, including by allowing suppliers more flexibility in setting prices to prepayment customers on the basis of grouping regional cost variations to make better use of their limited tariff codes. We support the proposed remedy to enhance prepayment customers' switching possibilities by implementing changes to the Debt Assignment Protocol by the end of 2016.
24. Debt blocking is a controversial issue, and we appreciate that views differ on its merits. However, this ability of suppliers to restrict customer movement is not characteristic of retail markets generally. We suggest the CMA might explore further the implications of relaxing or removing the provision for debt blocking.
25. Many of the problems in the prepayment market, including the relatively higher cost of supply, are associated with the traditional prepayment metering technology. The CMA and many respondents have emphasised the importance of the rollout of smart meters for improving competition, for example by lowering costs, resolving the lack of capacity for new tariffs, and giving greater flexibility to customers as to choice of payment method. In order to increase choice for PPM customers we would support giving further consideration to prioritising prepayment customers in the smart meter rollout, provided that such an approach was not detrimental to the efficiency of the overall rollout.

vi) *Helping customers engage*

26. The CMA proposes a series of remedies to address its weak customer response AEC. We do not accept the CMA's analysis which leads it to conclude that customers exhibit weak customer response. Rather, the CMA appears to assume that customers ought to act consistently with its own preferences.
27. The CMA recommends that Ofgem establish an ongoing programme of identifying, testing and implementing measures to promote engagement in the domestic retail energy markets. Given the problems the CMA has identified with Ofgem's previous interventions, we have reservations about recommending that Ofgem intervene further. To the extent that further regulatory interventions were to be considered, we support testing any proposed measures before their widespread implementation.
28. The CMA recommends that Ofgem introduce an additional 'standard of conduct' into Standard Licence Condition 25C that would require suppliers to have regard in the design of tariffs to the ease with which customers can compare 'value for money' with other tariffs they offer. We are concerned

that this would reintroduce the simple tariff restrictions, increase regulatory uncertainty and limit valuable innovation.

29. We support the CMA's proposals to enhance the ability and incentives of Third Party Intermediaries (TPIs) to promote customer engagement in the retail energy markets.
30. The CMA recommends the creation of an Ofgem-controlled database of 'disengaged customers' on default tariffs, to allow rival suppliers to prompt these customers to engage in the retail energy markets (the Database remedy). We question whether customer data should be made available in this way, whether customers themselves would support this, whether it would be effective, and whether it would be proportionate.

vii) Transitional price cap for PPM customers

31. We welcome the CMA's provisional decision not to implement a price control on Standard Variable Tariffs or equivalent, that might have covered some 70 per cent of domestic customers. We agree with the CMA that such a price cap "would likely be disproportionate", and "would – even in a transitional period - run excessive risks of undermining the competitive process, potentially resulting in worse outcomes for customers in the long run. This risk might occur through a combination of reducing the incentives of suppliers to compete and reducing the incentives of customers to engage." (para 7.17)
32. However, the CMA instead provisionally proposes to set a price cap on tariffs to Prepayment Meter Customers, that might cover about 16 per cent of domestic customers. We consider that the adverse consequences that the CMA correctly associates with a price cap on Standard Variable Tariffs apply equally to these tariffs. That is, a PPM price cap would undermine the competitive process with respect to PPM customers, potentially resulting in a worse outcome for PPM customers through a combination of reducing the incentives of suppliers to compete for PPM customers, and reducing the incentives of PPM customers to engage. It would hit hard the innovative existing Mid-tier PPM supplier and discourage new entry that is otherwise reported to be under consideration.

viii) Microbusiness remedies

33. The CMA finds weak customer response in the microbusiness sector and proposes a number of remedies designed to help microbusinesses engage in the market, including to increase price transparency, end auto-rollover contracts, provide information to prompt customers to engage, and provide prompts to microbusiness customers on default contracts by enabling rival suppliers to contact them. As in previous submissions, we are not commenting in detail on this sector. However, we have the same reservations about the concept of weak customer response as in the domestic market. We are also concerned that the provisional remedial measures may have unintended adverse effects in terms of reducing competition.

ix) Governance of the regulatory framework

34. We agree with the CMA on the importance of efficient and robust rules and regulations in the energy market. We support in particular the proposed deletion of paragraph 1C from both sections 4AA of the Gas Act 1986 and 3A of the Electricity Act 1989 so that OFGEM's statutory objectives and duties do not constrain its ability to promote effective competition. As regards the industry codes, we note the CMA's finding that parties have conflicting interests and/or limited incentives to promote and deliver policy changes and that OFGEM has insufficient ability to influence the code modification process. We support improvements in this area.
35. We have reservations about an annual Ofgem report on competition. Experience suggests that this could create a focus for pressure to intervene further in the market, particular in the immediate future before the CMA's remedies have taken full effect. A review of competition and the remedies package in, say, three years' time would seem more proportionate.

Section Two: The CMA's misleading analysis of the domestic retail market

36. The CMA's Chapter 3 summarises its updated thinking and analysis concerning the features contributing to its provisional AECs in the domestic retail market and the detriments arising from them. We comment here on four main aspects.

i) Weak customer response?

37. The CMA claims that many domestic customers are failing to choose lower priced offers that would be better for them. It does not acknowledge that customer engagement seems to have been reduced by regulatory interventions – see our subsection v) below. Its analysis assumes that energy is a homogeneous product such that only price counts. But for customers, suppliers and tariff types are also important. In our view, the CMA's analysis too-hastily rules out the possibility that customers see some significant differences between suppliers, or at least see their own existing supplier as preferable to other unknown suppliers. Ofgem's customer research has shown that customers trust their own supplier significantly more than they trust other suppliers. Similarly with tariff types, where customers may have a preference for, or aversion to, particular parameters such as variable or fixed tariffs, online or offline accounts, prepayment or credit rather than direct debit, etc. The CMA also undervalues the actual and subjective costs that many customers associate with changing suppliers and tariff types. The CMA essentially over-rules customers' own preferences and substitutes its own. Instead of acknowledging the significance of customer preferences, the CMA is led to the mistaken perception that this market is characterised by weak customer response.
38. To illustrate, the CMA's latest finding that there is "weak customer response" is buttressed by its scenario 5x calculation that the average annual potential saving available to a dual fuel customer of a SLEF is £164, or 14% of the

bill. (Appendix 3.2 para 26) In practice this would mean all customers switching from their existing tariff to an online, direct debit, fixed period tariff (except that those on PPM tariffs would switch to another PPM tariff). Under scenario 5x, over a half (54%) of customers could expect to save £100 or more, and a quarter (26%) could save £200 or more. (Appendix 3.2 Figure 1)

39. In our view, scenario 5x is an unrealistic assumption: it assumes that customers are indifferent with respect to tariff type (eg payment method, tariff structure (variable/fixed/capped), contract length, online/offline, exit fees, etc). In practice, many customers have strong preferences or constraints with respect to these parameters. Declining to choose a cheaper but different type is not a sign of weak customer response.
40. In our view, a more realistic scenario would be 3b, which holds constant these parameters and calculates the savings that would be available for the same tariff type. The average annual potential saving is now £65, or 6% of the bill. (Appendix 3.2 para 26) The proportion of customers that would save over £100 would be less than a quarter (24%) and the proportion that could expect to save £200 or more would be 8%. (Appendix 3.2 Figure 1)
41. In other words, a more realistic appraisal of customers' decisions suggests that potential savings on a like-for-like basis are significantly less than the CMA claimed, and that customers' responses are by no means as weak as the CMA suggests. With an average energy bill of nearly £1200 per year², a reluctance to devote time and effort to saving little over one pound per week is a credible and valid preference for many customers, entirely consistent with a competitive or "well-functioning" market, and not an indication of weak customer response.
42. The new data provided by the CMA also show that the savings available to customers of the Mid-tier suppliers are remarkably similar to the savings available to customers of the SLEFs. For example, under scenario 5x the average annual savings available to a dual fuel customer are £164 for a SLEF customer and £143 for a Mid-tier customer. Under what we believe is the more plausible scenario 3b, the savings are £65 and £72, respectively. (Appendix 3.2 para 26) And just as the savings available to dual fuel SVT customers of the SLEFs have increased from 2013 to 2015, so too did the savings available to such customers of the Mid-tier suppliers. (Figure 3.1)
43. In our view, this seriously calls into question the CMA's analysis and interpretation. The "existence of material, persistent gains from switching supplier, tariff and/or payment method that go unexploited by customers" was a major piece of evidence used by the CMA for the finding of weak customer response, enabling the SLEFs to exert unilateral market power. Yet this evidence shows that, in the most plausible scenario, average savings available to customers of the Mid-tier suppliers, who are likely to be among the most engaged in the whole market, are actually larger than average savings available to SLEF customers.

² The annual dual fuel bill averaged £1176 over 2010 – 2014 and was £1190 in 2014. Ofgem, *Retail Energy Markets in 2015*, 9 September 2015, Fig 2.6

44. All this suggests that the scenario 5x reported data are not measuring weak customer response or market power at all. They are simply a measure of the dispersion of prices that occurs in all markets. Indeed, there is long-standing evidence from the airline market that price dispersion cannot be explained by cost differences alone and is greater on more competitive routes.³ Considerable price dispersion is to be expected, not only where supply conditions vary, but also where customers incur transactions costs in changing consumption patterns, and where customers do not simply buy the cheapest items but have preferences for different products and suppliers.

ii) Excessive prices?

45. The CMA argues that weak customer response imposes a detriment on customers in the form of excessive prices charged by the Six Large Energy Firms. It has "direct" and "indirect" approaches to estimating the size of this detriment. Its direct approach calculates that the excessive charges on domestic customers averaged £1.7bn per year over the period 2012 to Q2 2015. It also claims the situation is getting worse: in the last year (2015) this total was £2.5bn. The CMA says "Our provisional view is that this may represent not simply a deterioration in competitive conditions over time but also an emerging revelation of the scale of detriment." (para 3.190)

46. This calculation compares the prices charged by the six large energy firms with what the CMA calls a "competitive benchmark price", which is taken to be a composite of the prices charged by two Mid-tier Suppliers (First Utility and Ovo).

47. We have several concerns about this calculation. For example, these two Mid-tier Suppliers are an order of magnitude smaller than the SLEFs. Together, they presently account for only about 6% of the market (and even less in previous years). For most of this period, they were not fully subject to the costs of environmental and social obligations. The CMA acknowledges that "their prices may reflect some differences in their cost bases in earlier periods" and notes that the larger suppliers and DECC estimate these costs at £45 - £60 and £36, respectively, per dual fuel account. (para 3.177 and fn 230) The CMA does not acknowledge that this might also affect the pricing policy of such suppliers: it is widely held that, once over the threshold at which the full obligation is due, smaller suppliers have an incentive to grow as quickly as possible, and therefore to hold their prices lower than they otherwise would. The CMA's remark that it therefore places more weight on the calculations for more recent years seems inadequate to reflect this effective subsidy that impacts on prices throughout the period and beyond.

48. The CMA notes that two SLEFs made similar points, submitting that the Mid-tier Suppliers' prices/profits were currently set below competitive levels, with the foregone profits in recent years representing an investment in future profits, and that the pricing of the Mid-tier Suppliers was not at a long-term sustainable level because of the stage of their business cycle. (para 3.192) The CMA's response – that these suppliers were likely to be profitable

³ Severin Borenstein and Nancy L Rose, "Competition and price dispersion in the US airline industry", *Journal of Political Economy*, 102(4), 1994: 653-683

in future – does not seem adequate to address these concerns, and does not acknowledge that any firm's pricing policy will naturally evolve as it grows and as the nature of its customer base changes.

49. Another SLEF submitted that the shorter-term hedging strategy pursued by some of the Mid-tier Suppliers would, in a rising wholesale market, have resulted in them incurring higher (rather than lower) wholesale energy costs than the Six Large Energy Firms. The CMA agreed, but argued that "if the Mid-tier Suppliers raised their prices we would expect this to lead to the Six Large Energy Firms increasing their prices as well, as the competitive constraint from the Mid-tier Suppliers would have relaxed". (para 3.197) Whether or how far the SLEFs would do this is debateable, but it does not address the point raised, which is that part of the observed price difference is simply an artifact of a falling wholesale market.
50. The concern we raised above - about the "evidence" for weak customer response ignoring customer preferences - is equally applicable to the CMA's calculation of excess prices. Customers evidently do not regard all suppliers as equivalent. Different prices therefore reflect a variety of factors, including preference for one supplier rather than another. The notion that a competitive market is characterised by all suppliers charging essentially the same price for a homogeneous product may reflect a theoretical concept of perfect competition but it is not a feature of competitive markets in the real world. If newer suppliers have to offer lower prices in order to persuade customers to switch to them, this is not an indication that the competitive market is not working, nor a measure of the extent to which customers that do not switch are charged excessive prices.

iii) *Excessive profits and inefficient costs?*

51. The CMA's "indirect approach" to assessing the detriment associated with weak customer response comprises an estimate of excess profits and an estimate of inefficient costs. In principle, the first part of this approach is to be expected. In assessing whether a real market is competitive, a conventional and accepted approach taken by competition authorities internationally, and by the Competition Commission and its predecessors in the UK, is to assess the nature and extent of excess profits in an industry. . However, we have reservations about the CMA's calculation. Instead of taking the actual costs incurred by the SLEFs, and calculating the return on the actual capital employed, the CMA substitutes its own assumptions about a hypothetically efficient but lower level of capital that, in its view, would be adequate to sustain such suppliers. Whether such a hypothetical supplier operating at the level of the existing SLEFs would have enough capital to survive over time in a uncertain environment is simply a conjecture: the reality is that this is not the business model that the SLEFs actually operate. The effect is to artificially inflate the alleged excess profit calculations.
52. Even so, on the basis of the CMA's own definition and calculation, aggregate excess profits in the domestic market over the last 8 years averaged about £241m per year. (para 3.209) With about 50m domestic energy accounts, this means that the CMA's "excess profit" averaged under £5 per domestic energy

account per year. That is less than £10 per dual fuel customer - in other words, less than 1 per cent of a bill of nearly £1200 per year. It seems entirely possible that, with calculations related to the SLEFs' actual business models, this alleged excess profit could shrink, disappear or even become negative. And as we suggest in subsection v) below, if any excess profit remains, part or all of it may be attributable to regulatory interventions rather than to market power.

53. In the second part of its "indirect approach", the CMA estimates that the SLEFs have higher (less efficient) indirect costs than the CMA's "benchmark competitive supplier", which it takes to be the lower quartile cost of the SLEFs. The difference averages some £290m per year over the 8 year period, or some £420m per year if the two lowest-cost SLEFs are excluded from the comparison.
54. The assumption that, in a well-functioning market, no firm would have costs higher than the lower quartile firm – that is, that three quarters of the output in a competitive market would be produced at equal cost – is quite unrealistic and inconsistent with the CMA's professed concept of competition as a rivalrous process rather than as perfect competition. And although the CMA *Guidelines* suggest the possibility of comparing actual costs against "efficient costs", no other Competition Commission or CMA investigation has ever actually done this. Nor, as far as we know, do other competition authorities use concepts of "efficient cost" and "inefficient cost" in evaluating market power or customer detriment in the context of a competitive market. .
55. The sum of "excess profit" and "inefficient costs" (averaging £241m + £420m = £661m per year) is the CMA's "indirect" measure of customer detriment. But even with the dubious assumptions noted, this falls about £1 bn short of the alleged £1.7bn excess charges to domestic customers. Since the alleged excess charges to domestic customers increase to £2.5bn in 2015, the unexplained difference perhaps increases to about £1.8bn. Here and elsewhere, the excisions in the CMA's tables and calculations make informed discussion difficult. Nonetheless, the same conclusion must be drawn as above, that the CMA's alleged £1.7bn or £2.5bn of excessive charges are an artificiality.

iv) *Perfect competition or competition as a rivalrous process over time?*

56. In its *Guidelines* and in the *Provisional Remedies* (para 3.152), the CMA affirms that its benchmark concept of a well-functioning market is based on a rivalrous process over time and not on perfect competition. A rivalrous process over time would be characterised by differences in prices, costs and profits. Yet in this investigation the CMA sees such differences as evidence that competition is not working. Indeed, it takes such differences as a measure of market power and customer exploitation. Its benchmark well-functioning market is evidently very close to that of perfect competition.
57. In any market, at any moment in time, firms will have different costs and prices. New entrants may have lower costs and prices than more established firms. This does not necessarily imply that the established firms are inefficient or that competition is not working. Adjustment to changing

conditions cannot be instantaneous. Some firms will adjust quicker than others. Rather than conclude that competition is not working, a more realistic interpretation is that cost reduction is difficult, and those established firms with higher costs have simply not yet discovered effective ways to reduce them. Over time, some established firms will adjust and survive, some may not, just as some new entrants will expand but others may not survive. Competition is the most effective process for testing these conjectures. For the CMA to assume, based on a snapshot at the present moment in time, that a well-functioning market would be characterised by firms with largely identical costs, and that prices would equal those offered by two small new entrants, is to misunderstand the nature of competition and to prejudge what cannot yet be known.

58. This suggests a somewhat different interpretation of retail energy market events than the CMA's. In the face of competition from other large suppliers, and increasingly from about 30 new entrants taking some 12% of the market, the SLEFs are in aggregate now losing market share. They are being forced to offer new tariffs at lower prices to try to retain their active customers and attract new ones, while maintaining prices to their less active customers in an attempt to cover apparently higher costs of operating their businesses. Over the last 8 years, four of the SLEFs have been barely successful in doing so – and in at least one case quite unsuccessful. Most of the profits over the last 8 years have been made by two of the SLEFs, another two were barely profitable and two were loss-making.⁴ The CMA does not consider the possibility that the higher profitability of two companies reflects superior performance in terms of cost control and customer acquisition in a competitive market, rather than excess profits. Indeed, more conventional calculations might well show no excess profits in this sector. Certainly there are price differentials, but the higher prices seem necessary to cover total costs, not to make excess profits, hence there may well be no excess charges on customers in aggregate. On the contrary, active rivalry between suppliers with innovation and substantial new entry suggest an effectively competitive market.

v) *The effect of regulatory interventions over time*

59. The CMA calculates (see above) an increase in "excessive charges" from an average of £1.7bn per year over the last 3 ½ years to £2.5bn in 2015. It refers to "a deterioration in competitive conditions over time". The CMA also comments "We observe that there appears to be a step-change in the profitability of the Six Large Energy Firms from 2009 onwards, which may be indicative of a change in competitive conditions in the GB retail energy markets." (para 3.224 fn 242) Surprisingly, the CMA does not ask *why* there was this step-change in competitive conditions in the GB retail energy markets from 2009 onwards.

60. The CMA continues "Using a shorter period does not materially change the average level of profits in excess of the cost of capital earned on SME

⁴ Average annual profits over the six years 2009 – 2014 were Centrica £586m, SSE £230m, E.On £80m, SP £79m, RWE minus £17.5m, EdF minus £100m. Ofgem, *Understanding the profits of the large energy suppliers*.

customers." Again, it does not ask why profits increased in the domestic market but not in the SME market.

61. The number of new entrants in the domestic market is now about 30, and since 2009 their market share has steadily increased to about 12 per cent of domestic customers. How has there been "a deterioration in competitive conditions" in the domestic market at the same time as there has been such a significant increase in new entry?
62. Movements in wholesale energy prices have been in both directions over this period, and would apply to the SME market too. So this cannot be the whole of the explanation for increasing profits in the domestic market.
63. A important explanatory factor missing from the CMA's analysis is surely the impact of regulatory interventions. The CMA has acknowledged that Ofgem's non-discrimination condition SLC25A, proposed in 2008 and implemented in 2009, is likely to have restricted price competition in the domestic market. Ofgem's more severe regulations with respect to direct marketing (including doorstep selling) were instrumental in the SLEFs giving up those activities in 2011 and 2012. The CMA has provisionally found that Ofgem's RMR "simple tariff" restrictions, proposed in October 2012 and implemented by late 2013, have had an Adverse Effect on Competition.
64. The CMA tends to see these regulatory interventions as restricting innovation, which is true, but we believe their effects have been more far-reaching. The interventions have had predictable, substantial and demonstrable adverse impacts on the competitive market for domestic customers. They have reduced customer engagement: specifically, customer switching (annual churn), which had been steadily increasing from 15% in 2003 to 20% in 2008, fell to 10% by 2013. (Churn has recovered slightly since then, partly as a result of Government switching campaigns, but is still under 13%.) The adverse effect seems to have been particularly severe for those customers who previously responded most to direct marketing.
65. The regulatory interventions also seem to have increased profits (EBIT) of the large suppliers by about £1bn per year: the average over the eight years 2007 to 2014 is £696m per year, but this masks an increase from an aggregate of £110m in 2007 and minus £6m in 2008 to £1211m in 2012, £1148m in 2013 and £1159m in 2014.⁵ Negative profits are clearly unsustainable. Whether an aggregate profit of about £1bn per year is to be expected in a competitive market, or is too high or too low, is a matter of judgement. The CMA's view is that £241m of that is excessive, but its calculations are questionable, and a more realistic calculation would yield lower and perhaps zero or negative excess profits. However, to the extent

⁵ CMA, Appendix 10.2, *Retail energy supply profit margin analysis*, 10 July 2015, Table 5, and *Understanding the profits of the large energy suppliers for 2014*,. Ofgem website. There is also a comparable increase in ROCE. CMA, Appendix 3.4, *Analysis of Retail Supply Profitability – ROCE*, 18 March 2016, Tables 1, 2, 3, 4. Note that these EBIT profits are before the payment of dividends, hence exclude that element of the cost of capital, and in that sense are not directly comparable with the "excess profits" calculated by the CMA, which are after the assumed cost of capital has been deducted.

that there are any excess profits in the domestic market, an increase in profits of around £1bn per year associated with regulatory interventions must surely be a significant explanatory factor.

vi) Implications of the regulatory interventions

66. This history of regulatory interventions since 2009 has at least four significant implications for the present CMA findings and remedies.

- First, insofar as Ofgem's regulatory interventions have caused, or at least facilitated, the increase in supplier profits in the domestic market, they must to some extent be responsible for the existence, continuation and growth of the CMA's "excess profits". Also, amongst other things, these interventions have prevented the use of SVTs as "acquisition tariffs" (see para [70] below), and thereby accentuated the price difference between SVTs and fixed tariffs that is of concern to the CMA.

- Second, insofar as Ofgem's regulatory interventions have halved the extent of customer switching, they should be held responsible for a significant part of what the CMA claims is "weak customer response".

- Third, insofar as Ofgem's regulatory interventions have significantly reduced competition, then to the extent that the CMA's proposed remedies rescind these interventions this can be expected to reinstate more active competition in the market, not least between the SLEFs themselves. Similarly, it would promote more active engagement in the market, and hence address the CMA's weak customer response AEC more quickly and effectively than the CMA allows. (Having said that, the CMA's refusal to examine some continuing restrictions, for example on direct marketing, is a remaining weakness, as discussed below.)

- Fourth, as a result of the above, the case for additional and more drastic measures to address the weak customer response AEC, such as making loyal customer contact details available on a database, and especially the reintroduction of price controls, is correspondingly called into question.

vii) Conclusions on the CMA's analysis of the domestic retail energy market

67. In our view, the CMA's analysis of the market is seriously inaccurate and incomplete. It is inaccurate because it is based on a series of unrealistic or questionable assumptions. It claims the existence of large price differentials unexploited by customers. But once customer preferences are taken into account the available price differentials are significantly lower than those suggested by the CMA. It is more plausible to see observed customer behaviour as a result of a preference for particular suppliers and particular types of tariff, and taking into account the costs of engaging in the market, than as "weak customer response". The CMA claims £1.7bn and £2.5bn per year of excessive prices, whilst aggregate reported profits are about £1bn per year. The CMA's calculations result from questionable assumptions about cost comparability of new entrants and larger firms, as well as the same failure to consider customer preferences between suppliers and tariff types. The CMA calculates excess profits of £241m per year in the domestic

market, but bases this on the conjectured capital requirements of a hypothetical capital-light supplier rather than those of the actual suppliers. The CMA claims that existing SLEFs have inefficient costs amounting to £420m per year, based on the unrealistic assumption that in a well-functioning market no firms would have costs above the lower quartile level.

68. The CMA's account is incomplete because it takes inadequate account of the impact of Ofgem's regulatory interventions since 2008, which the CMA has found have reduced competition. The CMA has not considered the extent to which this reduction in competition contributed to the fall in customer engagement especially the switching rate, and the increase in aggregate profits (and presumably the CMA's "excess profits") observed thereafter.
69. Thus, in our view, the CMA's *Provisional Findings* and *Provisional Remedies* do not provide a proper understanding of the domestic retail energy market. They do not provide a sound basis for further intrusive and anti-competitive regulatory interventions, particularly the reintroduction of price controls.
70. Rather than seek the most considered, responsible and defensible analysis of the domestic retail market, the CMA seems to be seeking out the assumptions and interpretations that maximise the extent of customer detriment. This represents a change in stance from that taken by the former Competition Commission (CC), and it is not one that will increase trust in the CMA.

Section Three: Further discussion of the provisional RMR remedies

i) Removing existing RMR restrictions

71. The CMA proposes to remove a number of existing RMR restrictions (the four tariff rule and bans on complex tariffs, discounts, bundled products, reward points and tariffs exclusive to new or existing customers) and to deprioritise enforcement of the related licence conditions until they are removed. We strongly support these proposed remedies, for the reasons that the CMA gives.

ii) Standard of Conduct to design tariffs to compare value-for-money

72. The CMA proposes a new Standard of Conduct that would require suppliers to have regard in the design of tariffs to the ease with which customers can compare value-for-money with other tariffs they offer.
73. We are not convinced that such a licence condition is needed in order to enable customers to assess value for money, or that it will have a significantly beneficial impact in that respect. On the contrary, there will be uncertainty about its meaning and enforcement, and it will add a further regulatory burden on suppliers that will eventually get passed through to customers. The significant innovations in energy tariffs since the competitive market opened – such as tariffs with no standing charges, fixed price

contracts, the Staywarm tariff, initial discounts and cashback – are important because they are different, and *not* directly comparable with the Standard Variable Tariff. The proposed Standard of Conduct thus harks back to Ofgem's "simple tariffs" requirements. It does not seem consistent with the CMA's findings on the adverse effects of those requirements, and with its explicit view on innovation and regulatory restrictions.⁶ It could also be misinterpreted by Ofgem, which appears to continue to oppose much tariff variation.⁷

iii) Dead tariffs

74. The CMA proposes "to keep the requirements concerning dead tariffs as we see no obvious pro-innovation reasons for allowing suppliers to keep those tariffs". (para 5.398) It continues "We consider that these restrictions address concerns that dead tariffs allow suppliers to segment the market and their removal may undermine our remedies concerning the Domestic Weak Customer Response AEC by contributing to customer confusion as they may find it difficult to find details of their dead tariffs for comparison."
75. However, allowing suppliers to maintain dead tariffs may enable them to compete, and even to innovate, by cutting the prices of their evergreen products to some new and existing customers that they would not otherwise be willing to do, or to do only later. Prohibiting dead tariffs, and insisting that all evergreen tariff customers must pay the same price, may thus prevent some of those customers from getting a better price.

iv) Amending or removing the information tools

76. The CMA then considers the implications for other aspects of the RMR rules.

5.424 ... Ofgem said the methodologies for calculating the 'Tariff Comparison Rates', Personal Projections' and 'Cheapest Tariff Messaging' would need to be revisited to ensure that the tools continue to serve their policy intent. Ofgem has submitted that these tools were not designed to accommodate multi-tier tariffs and a wide variety of discounts and bundles. Ofgem has also submitted that a tariff with multiple unit rates would require multiple lines in the 'Tariff Information Labels' which might be confusing.

The CMA is "currently minded to maintain the information tools introduced as part of the RMR rules, and propose[s] to make a recommendation that Ofgem makes the necessary methodological amendments". (para 5.426)

77. We question whether these three Ofgem-specified calculations, now to become more complex, are the most sensible and effective way to provide

⁶ "Generally we consider that the interests of consumers are better served by promoting innovation and competition rather than imposing restrictions that might adversely impact on the incentives and ability of suppliers to respond to competition." (para 5.391)

⁷ "Ofgem said that it did not want to return to the 'confusopoly' that existed prior to the RMR rules and that multi-tier tariffs, tariffs with multiple components and loyalty discounts might make tariff comparisons more difficult." (para 5.376)

the many different types of customers with the information that is of most relevance and interest to them, in a market where products themselves are becoming ever more complex. In certain respects they have already been criticised as being misleading.⁸ They may also restrict competition: the obligations to advise customers of the cheapest evergreen tariff and to transfer customers from dead tariffs to the cheapest evergreen tariff, are presumably among the reasons why SVTs are no longer used as "acquisition tariffs": the licence conditions provide an artificial incentive to increase rather than reduce the SVTs. Given also the concern about energy bills overloading customers with information, we consider that there is a stronger case for removing these obligations, and letting existing and rival suppliers and PCWs and others discover the best way to provide information to customers.

Section Four: Further discussion of the provisional weak customer response remedies

78. The CMA proposes (in its Section 6) a package of five remedies to help customers engage better in the market. As explained above, we do not believe that customer response is weak and constitutes an Adverse Effect on Competition, hence we see less need for remedies. The advantages or disadvantages of four of them merit comment. (We do not comment on the proposals with respect to restricted meters.)

i) An Ofgem programme to provide customer information

79. The first CMA proposal is that Ofgem should establish a programme to provide customers with information to prompt them to engage. The CMA notes Ofgem's existing licence conditions to this effect, but is concerned that the provisions were not tested before or after their introduction. Instead of repealing them the CMA proposes that Ofgem establish a programme to test them, which might lead to their repeal or amendment over time.

80. This proposal implicitly assumes that there is a single set of best ways to provide different kinds of customers with information, that Ofgem is well placed to direct the research and interpret the results, and that the chosen ways should then be imposed on all suppliers. It assumes that the relevant pieces of information and how best to present them will remain unchanged over time, despite products and technologies changing ever more rapidly, not least as smart meters come into play. It assumes that such an approach is more likely to be successful in informing and appealing to customers than allowing the competitive market process to work. That process would allow market participants, who have a direct commercial interest in informing customers about the existence of better offers, and motivating customers to respond, to discover and implement the best ways of communicating with them.

81. As we noted in our last submission (14 January 2016), the Government has put in place a new Steer to the CMA. This explains that "The Government is

⁸ E.g. *How to save £520 a year on a £438 energy bill?* Research by theenergyshop.com, March 2016

committed to removing unnecessary regulatory burdens on businesses wherever possible. ... The CMA can play a significant role in reducing burdens on businesses and securing better outcomes for consumers by ... partnering with economic regulators to use effective competition tools to promote changes in markets rather than prescriptive licensing conditions and regulatory requirements." The Steer is not binding on the CMA, but the CMA Chairman has said that the CMA should be "sensitive to political currents".

82. The proposed programme to provide customers with information is indeed intended to lead to "prescriptive licensing conditions and regulatory requirements". It seems inconsistent with the ever-changing and innovative competitive market that the CMA wishes to promote, and with the Government's new Steer. It will restrict the ability of individual suppliers to discover and provide what their customers want, and will thereby restrict competition. The costs and disadvantages of the proposal seem disproportionate to the conjectured possible benefits.
83. The CMA is understandably concerned to assist those customers who "lack the capability to search and consider options fully". (para 6.9) It would seem more effective and proportionate to facilitate means of advising them that are more directly geared to their personal circumstances - for example, via personal advice, local authority involvement, vulnerable customer organisations, and/or TPIs and PCWs, as envisaged by some of the CMA's other remedies.
84. To that end, we repeat our concern from previous submissions that the CMA has not examined the adverse consequences of the licence conditions related to direct marketing. Our understanding is that these conditions make it difficult and/or unduly risky to explain to customers in person the nature of the tariffs available, often cause information overload for customers, and make suppliers wary of trusting TPIs to act on their behalf. This is particularly the case with respect to PPM customers.⁹ Consumer legislation already protects customers against bad selling tactics, and it is not clear why licence conditions need to be imposed beyond that. We therefore recommend that the CMA examine the licence conditions related to direct marketing with a view to reducing the cost of direct marketing and helping all customers to engage better in the market, not least vulnerable customers and PPM customers.

ii) Principles v prescriptive rules

85. The CMA's second proposed remedy is "Ofgem making greater use of principles rather than prescriptive rules in addressing potential adverse supplier behaviour concerning the comparability of tariffs". (para 6.7b) This appears to relate only or primarily to the CMA's proposed new Standard of

⁹ "3.50 We have also received some evidence on the extent to which prepayment customers are acquired through more expensive marketing channels relative to direct debit customers, and therefore on the extent to which this reduces suppliers' current incentives to compete to acquire prepayment customers. 3.51 In particular, Scottish Power told us that as few as []% of its prepayment customers had been acquired through PCWs. The rest were acquired through more expensive channels, including external sales ([]%) and face to face ([]%)."

Conduct that would require suppliers to have regard in the design of tariffs to the ease with which customers can compare value-for-money with other tariffs they offer. Our views on that are set out above.

86. More generally, while we see advantage in avoiding excessively detailed and restrictive prescriptions in licence conditions, we recognise also that licensees may well have difficulty in understanding or predicting how a regulator might interpret a particular stated principle. The FSA began with an intention to use principles-based regulation and, as a result of interpreting it, we understand that the FCA ended up with a rule book over 6 feet high. We therefore have reservations about the general principle of moving to principles based regulation. If a main concern is to avoid restricting innovation, the remedy is not to be so prescriptive in the first place, rather than to be prescriptive in a principles-based way.

iii) Enhancing the incentives and ability of PCWs to engage with customers

87. In order to enhance the incentives and ability of PCWs to participate in the market, the CMA provisionally recommends that Price Comparison Websites (PCWs) have greater access to databases associated with customer transfers, subject to satisfaction of reasonable access conditions; that PCWs have increased access to more customer data via the MiData programme (subject to customer consent); and that the Whole of the Market Requirement be removed from the Confidence Code. We welcome these proposals, which will facilitate competition and the provision of new and better services to customers, including by enabling PCWs to monitor the market on behalf of their customers and advise them of savings.
88. The CMA does not now intend to encourage customers to use more than one PCW or recommend that Ofgem set up and operate a non-transactional website listing all tariffs. We support these decisions. As tariff offerings become increasingly numerous and varied, the practicality and impact of a website listing all tariffs would be doubtful. It could distort the competitive market for PCWs, and it would add an additional, distracting and inappropriate role for Ofgem. The CMA's other proposed remedies make it unnecessary.

iv) Prompts for customers on default tariffs

89. The CMA proposes to require suppliers to hand over to Ofgem details of their "disengaged" customers that have been on a Standard Variable Tariff for three or more years, with a view to Ofgem retaining, using and disclosing these data to rival suppliers, subject only to a customer opt-out provision.
90. The CMA notes that questions have been raised as to whether this remedy is consistent with statutory confidentiality provisions. The CMA also reports a large number of objections to this proposal. We share these concerns.
91. The CMA explains (para 6.240) that the French competition authority, in the context of an investigation of the abuse of a dominant position by the incumbent gas supplier (Engie, formerly GDF Suez), successfully applied for an interim order requiring Engie to share certain customer details with other

gas suppliers. It says nothing of the nature of this alleged abuse, or the extent of Engie's dominant position. As to the outcome of this measure, it says only "The French competition authority advised us that a reasonably large proportion of domestic customers, [□]. As a consequence, [□] were included in the first iteration of the database." (para 6.244) What constitutes a reasonably large proportion of domestic customers, and what they did, are left unexplained. The CMA says nothing of what the subsequent outcome was, what action competitors took, and importantly what customers did and said. This is not conducive to informed assessment of this approach.

92. The French competition authority's statement explains that, seven years after the French gas market opened, new entrant competitors had taken only 5% of domestic customers and EDF a further 9%, leaving Engie with 86% of domestic customers. The French competition authority held that "GDF Suez might have abused its dominant position in the gas market by using the infrastructure dedicated to regulated tariffs (i.e. customer database, website, customer platform...), which is in the realm of a public service activity, to market its gas and electricity offers, which are marketed in a competitive market."¹⁰
93. This is not a tenable argument in the UK, where there are no regulated tariffs or public service activities, and where competitors have demonstrably been able to take significant market shares from the former incumbents, who no longer have dominant market positions. Thus, UK competitors to Centrica now have 63% of the domestic gas market leaving Centrica with 47%. In electricity, previous incumbents have between 66% of the market (in North of Scotland) and 24% (in Northern's area), with a median market share of about 32%. The contrast in the SME market is even greater.¹¹
94. We question whether customer data ought to be handed over without good reason, whether customers themselves would wish to be subjected to the proposed disclosure process, whether those customers who fail to opt out will welcome the subsequent and presumably repeated barrage of marketing, and whether a regulatory body ought to lead such a process. If this proposed remedy goes ahead, it would be preferable for customers to be invited to opt in to such a process rather than be required to opt out, though whether such an approach would have the desired effect is debateable. In either case, it would be prudent to conduct a trial beforehand.
95. The CMA has apparently not considered how the suppliers of these disengaged customers might respond to the proposed remedy. Might they take steps to transfer customers to other tariffs or to persuade customers to remain with them, and if so would customers be better or worse off as a result, and would the remedy then need to be strengthened or modified, or even more detailed information requirements put in place?

¹⁰ French Competition Authority Press release 9 September 2014: Gas Market. For market shares, see the Authority's Decision No 14-MC-02 of same date.

¹¹ Engie still retained 74% of the SME gas market share whereas in the UK gas market Centrica has only 22% market share, and the former electricity incumbent median market share is 29% (range 24-40%). (Ofgem, *Retail Energy Markets 2015*, Figs 2.2 – 2.4)

96. Again, we question whether the elaborate and far-reaching procedures envisaged here have sufficient potential advantages to offset the potential disadvantages.

Section Five: Price controls for prepayment meter customers

97. The CMA has decided not to propose a transitional price cap on SVT tariffs. We welcome that decision. However, the CMA now proposes to impose such a cap on PPM tariffs. The case for this seems weak, given that the CMA finds that PPM customers are no less engaged than Standard Credit customers (para 3.109). Unexploited savings from switching (a reason why the CMA found weak customer response for domestic customers generally) are much lower in the PPM market than for Direct Debit and especially Standard Credit customers (Appendix 3.2 Tables 4, 43-45). Nonetheless the share of PPM customers taken by independent suppliers grew by 35% over the last six months of 2015 (para 3.84). As elsewhere, regulatory interventions have impacted adversely on customer engagement, particularly the direct marketing restrictions in this case. We consider that the proposed price cap would be unwise, and inconsistent with the CMA's stated policy.¹² Our focus here is on the likely consequences of such a cap.
98. The CMA estimates (para 7.161) that, with £50 dual fuel headroom (£25 per fuel), its proposed PPM price cap would reduce the annual revenues of the SLEFs by £303 million. It continues that "In financial year 2014 earnings before interest and tax (EBIT) generated by the Six Large Energy Firms from their domestic supply was £1,193 million. For illustration, a revenue reduction of ... £303 million would represent a reduction in the domestic supply EBIT of the Six Large Energy Firms of ... 25.4%."
99. The £303m reduction in revenue exceeds what the CMA calculates as the excess profits of these companies in the domestic market (an average of £241m per year over the last 8 years). The CMA does not disclose the impact by company. A market analyst has estimated that it would represent a revenue reduction of around 20% for four of the SLEFs, nearly 50% for a fifth, and the sixth firm is already loss-making.¹³
100. Such impacts would have far-reaching consequences. For example, it is implausible that these suppliers would not seek to recover such a reduction in revenues by adjusting their pricing of other products. The reduced revenue from PPM customers would thus be offset by higher prices to Standard Credit and Direct Debit customers.

¹² "Generally we consider that the interests of consumers are better served by promoting innovation and competition rather than imposing restrictions that might adversely impact on the incentives and ability of suppliers to respond to competition." (para 5.391)

¹³ *UK Utilities: How will the CMA pre-payment safeguard tariff work and what is its impact?* Deepa Venkateswaran, Bernstein, March 21, 2016

101. The CMA fails to acknowledge and consider this unintended consequence. This is reminiscent of the sequence of events surrounding Ofgem's price discrimination condition. Ofgem initially focused only on the promised reductions in prices, and was later forced to acknowledge that the policy could lead to comparable increases in other prices in order to maintain the aggregate level of supplier net revenue. In the event, supplier profits increased, and the CMA now finds that Ofgem's intervention contributed to a softening of competition.
102. Perhaps the CMA is relying on Supply Licence Condition (SLC) 27.2A, which provides that suppliers cannot charge more for one payment method than another unless the price differential can be justified by the cost difference. Would this mean that a price cap on PPM tariffs would effectively be a price cap on tariffs for all payment methods - that is, on all tariffs? It would be helpful for the CMA to clarify this point.
103. The CMA notes that "The price cap will also apply to Mid-tier Suppliers and smaller suppliers and will therefore result in revenue reductions outside of the Six Large Energy Firms. [] []." (para 7.162) It gives no public indication of the likely extent and implications.
104. For some suppliers, these implications could be drastic. Utilita, a new entrant supplier, has specialised in offering smart meters, better service and lower prices to PPM customers. Its business has grown significantly over time. The market analyst report just cited estimates that the proposed price cap would imply a reduction in Utilita's PPM tariffs by £30, which would reduce its profit from £10m to £3m, a hit of about 70 per cent. This would be an overwhelming blow for such a valuable and innovative competitor, to which the CMA appears to attach no weight.
105. Citizens Advice has said that a range of different organisations are planning to enter the market to focus on serving PPM customers.¹⁴ The price cap would discourage such suppliers from entering, to the detriment of PPM customers. And whereas some existing suppliers have been considering new products for PPM customers (as instanced in para 7.176), a price cap would again discourage them from doing so.
106. The CMA dismisses the possibility that existing suppliers would reduce quality of service to PPM customers. Yet with PPM customers now significantly less profitable, and in some cases actually unprofitable, suppliers will inevitably be led to focus their efforts and resources on keeping and attracting non-PPM customers. It would be very surprising if, in various respects, PPM customers did not suffer as a result.
107. The CMA expresses confidence that this price control would be a transitional measure. However, many developments, such as delays to the smart meter installation programme or modifications to it, could lead to

¹⁴ "Citizens Advice has spoken to a range of different organisations, many of which are non profit or social enterprises, that are planning to enter the prepayment market...The common theme with each of these organisations is that they are looking to establishing local partnerships with housing associations, local authorities or community groups in order to reach prepayment meter users." (Citizens Advice, submission to CMA of 6 January 2016)

demands to extend the price control. Or it might be argued that further time is needed for customers generally, or PPM customers in particular, to become more engaged in the new market. Or that the removal of the price cap would likely lead to undesirable increases in prices, potentially of the same magnitude (£300m revenue) as the estimated reduction following the original price cap.

108. Although the PPM price cap is partially justified in terms of its beneficial impact on vulnerable customers, PPM customers are by no means the same as vulnerable customers. To illustrate, only 29% of the fuel poor customers use PPM. 23% use Standard Credit and fully 40% are on Direct Debit.¹⁵ So a PPM price cap affects only a minority of fuel poor customers. Moreover, only 22% of PPM customers are fuel poor. So more than three quarters of the customers impacted by a PPM price cap are not fuel poor. A PPM price cap is thus a blunt instrument for addressing fuel poverty. Indeed, insofar as it is likely to lead to an increase in other tariffs, it is likely to make many fuel poor worse off. Ofgem seems to have come to a similar conclusion in its decision not to remove or regulate payment differentials.¹⁶
109. If a PPM price cap were put in place, this could open the floodgates. It would establish the precedent that, not only in principle but also in practice, any kind of intervention in the competitive market could be entertained. It would invite further lobbying to extend the duration and coverage of the control, and more generally to intervene in other ways. The lobbying would come, not only from customers and their representatives, but also from suppliers and potentially other market participants who might judge that their own interests would be furthered by restrictions on the revenues or tariffs of the SLEFs or other suppliers. Apart from the likely adverse effects of such measures, the additional regulatory uncertainty would increase the costs and risks faced by suppliers, with corresponding adverse effects on competition, prices and customers.
110. For all these reasons, we consider that this proposed PPM price cap would have similar adverse effects to those that the CMA acknowledges would accompany an SVT price cap. Such a cap would not be in the interests of PPM customers in the long run, or of the development of the competitive market and customers generally. Relaxing the direct marketing restrictions would be more helpful. Removing the other RMR restrictions will enable more competition for PPM customers. If it is desired to further protect vulnerable customers, including the fuel poor, a better targeted approach would be to extend the Government's Warm Home Discount scheme and to encourage the various energy trust support schemes for vulnerable customers run by all or most of the SLEFs.

¹⁵ *Consumer vulnerability strategy progress report*, Ofgem, September 2015, p 17

¹⁶ There have been a number of calls to remove price differentials or to regulate them to address what some see as a 'poverty premium'. To inform the debate, we analysed what the potential effect would be on fuel poor households if payment differentials were removed. Our research indicated that equalising PPM and SC differentials could make around half the fuel poor (45%) worse off as just under half of all fuel poor pay by DD. It may not therefore deliver the social outcomes some expect." Ofgem, *Ibid*, p 18

Section Six: Wider implications of the CMA's analysis of the retail energy market

111. The CMA's approach to analysing the retail energy market could have very far-reaching adverse effects if generalised to other market investigations.
112. The CMA would discover smaller new entrants offering lower prices, and larger established firms offering some lower priced product ranges to compete with them. But since many customers are not attracted to these lower priced products, the CMA would conclude that this constituted "weak customer response", that there was no justification for customers paying the higher prices, and that this constituted an Adverse Effect on Competition. The CMA would quantify the extent of excess charges that the larger firms were imposing on their customers by calculating the annual value in £m of the difference between the higher price products of the larger firms and the lower price products of the entrants. It would regard as unimportant any product differences, how long the new entrants had been in the market, and whether they were actually making a profit.
113. The CMA might calculate that the larger firms were making an excess profit above the cost of capital, albeit rather modest and only a fraction of the alleged excess charges to customers. But it would argue that this was because the lack of competition was reflected in the inefficiently high costs of most of the established firms. The fact that the calculated excess profits plus inefficient costs still bore no relationship to the calculated excess charges would carry no weight with the CMA.
114. The CMA would then argue that all this evidence of an AEC, and of excessive prices, profits and costs, necessitated an extensive and substantial set of remedies to protect customers. These might require the companies to offer more comparable products or to provide better information to customers. They might also require the larger firms to provide details of their loyal customers who had purchased their higher priced products for at least three years, so these details could be given to rivals to try to attract away their customers. And it would be necessary to control the prices of some of the higher priced products, at what the CMA deemed an efficient level, until these customers learned to be more responsive to price, to switch suppliers more frequently, and to purchase lower priced products rather than higher priced ones.
115. What would observers, customers and investors make of such an approach? Would they consider that this was a prudent evaluation and resolution of the problems in this market, or that the CMA's analysis had gone seriously awry? Would they not consider that its arguments and calculations seemed to overlook some significant points? That its proposed remedies were quite disproportionate and counter-productive, and contrary to the present Government's pro-competitive and anti-regulatory Steer? That if this approach were taken across the economy as a whole there would be a very considerable extension of regulation and intervention? That this intervention would be more likely to restrict competition than promote it, more likely to deter investors and entrants than encourage them, and more

likely to harm customers than to protect them? That uncertainty about where the CMA would strike next could have a significant impact on market sentiment and on the cost of capital?

116. The CMA has argued that "energy is different" because it is a homogeneous product. This is not a plausible defence. We have argued above that physical characteristics are not the only relevant consideration. *In the view of customers*, products and suppliers may vary considerably. The CMA does not give weight to these customer preferences.
117. The CMA's approach to the retail energy market could be applied to any retail market. By the CMA's definitions, the potential for finding weak customer response, excessive prices to customers, excessive profits and inefficient costs, is enormous. And the CMA's recipe is not to let the competitive market process work but to intervene to impose what it thinks would or should be the outcome if the market were "well-functioning" and all competitors had a return equal to what it deemed to be the efficient cost of capital and "efficient costs". The logic of this argument would be to intervene in every market where new entrants were challenging incumbents – that is, in every market that was not in or near a state of perfect competitive equilibrium. This is not a characterisation of real competitive markets, and does not seem a sensible direction for UK competition policy.

From:

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

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