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Providing for a transition back to a competitive retail energy market: A response to the CMA's Invitation to Comment on its proposed review of the Prepayment Charges Restriction Order 2016

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1. Summary

The CMA has invited comments on whether to review its Prepayment Charges Restriction Order 2016, and if so on the appropriate scope of such review. It proposes three questions, to which this response answers as follows:

- Yes, the CMA should prioritise the Order for review at this time, not only for the reasons suggested by the CMA (importance of the energy market for consumers and prepayment meters often used by vulnerable consumers), but also because it is important that the CMA take early steps to provide for a transition back to a competitive retail energy market undistorted by tariff caps.
- Yes, it is appropriate for the scope of the review to include (i) assessment of progress concerning the rollout of smart meters, not only because this issue has featured in CMA and Government discussion of tariff caps and because the expected timetable for implementation has not been met, but also because there is now evidence that metering constraints do not have the adverse impact on the effectiveness of competition than was thought at the time the CMA set the Prepayment (PPM) Tariff Cap, and to include (ii) assessment of the CMA's calculations of the specified elements of the tariff cap, not only because suppliers have expressed concerns about such matters, but also because further analysis and empirical evidence provide reason to believe that the CMA's Energy Market Investigation (EMI) underestimated the extent of competition in the market, overestimated the customer detriment, underestimated the competitive market price, and in consequence set the PPM tariff cap at an unduly low level.
- Yes, additional calculations of cost categories and broader elements of the Order should be subject to review, particularly the Headroom component, because the unduly low level of the PPM tariff cap, and the present "cliff edge" nature of both that cap and the default tariff cap, will make it politically difficult to remove the caps even where competition could be effective, hence there is a need for the CMA gradually to phase out the PPM tariff cap and thereby help Ofgem, in parallel, gradually to phase out the default tariff cap.

The CMA's *Guidance* provides for possible variation of Orders if there has been a relevant change of circumstances. There is evidence of three such changes of circumstance since the

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issue of the CMA's *Final Report* on its EMI in June 2016 and the Prepayment Charges Restriction Order in December 2016. These changes are associated with

1) the decisions of Government and Parliament to reject a key argument in the *Final Report*, namely the CMA(EMI)'s view that a wider tariff cap was not appropriate,

2) market developments since 2016 confirming the competitiveness – or increased competitiveness - of the domestic retail energy market, including in the PPM sector, and

3) further analysis (including in the light of these developments) suggesting that the *Final Report* understated the extent of competition in the market and overstated customer detriment.

These changes of circumstance make it appropriate for the CMA to modify the Order. Specifically, the CMA should take steps to phase out the PPM tariff cap by December 2020, which in turn could enable Ofgem to likewise phase out the default tariff cap, consistent with the Tariff Cap Act.

2. Government and Parliamentary response to the CMA *Final Report*

In June 2016 the *Final Report* by the CMA(EMI) – this term is used to distinguish that particular CMA panel from the CMA itself – found (inter alia) two related Adverse Effects on Competition (AECs): the Domestic Weak Customer Response AEC and the Prepayment (PPM) AEC. To remedy the first AEC, the CMA(EMI) recommended that Ofgem take certain measures to encourage greater customer engagement. The CMA(EMI) considered that "weak customer response is a more significant problem among prepayment customers", who were often more vulnerable customers, and it also identified certain restrictions in PPM metering. To remedy the PPM AEC the CMA(EMI) issued an Order to implement a PPM tariff cap until December 2020, at which time it was expected that the introduction of smart metering would remove the previous restrictions.

The CMA(EMI) explained why it decided against extending the PPM tariff cap to a more general SVT and default tariff cap:

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

In a dissenting minority report, Professor Martin Cave took a different view:

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

In an earlier response to the CMA(EMI) *Provisional Remedies*, economists from the University of East Anglia Centre for Competition Policy warned that the majority position seemed implausible.

> "Overall we find it surprising that the majority of the CMA panel does not feel that stronger interventions are justified if they believe their detriment estimates are robust. Either the CMA has substantially overestimated the detriment of non-engagement or the majority of the panel

> are being extremely optimistic about their ability to raise consumer engagement." (Deller, D, Hviid M and Waddams, C, 8 April 2016 (posted 21 April) at https://www.gov.uk/cma-cases/energy-market-investigation)

In the event, the media, the Government and ultimately Parliament effectively agreed with this diagnosis. And they sided with Professor Cave against the CMA(EMI) majority. In doing so, they repeatedly cited the CMA(EMI) £1.4bn and £2bn customer detriment calculations. On 26 February 2018, the Secretary of State introduced the Domestic Gas and Electricity (Tariff Cap) Bill. The Bill required GEMA (the Gas and Electricity Market Authority, parent body of Ofgem) to "impose a cap on all standard variable [SVT] and default rates", until at least 2020 and possibly until 2023. The Bill became law on 19 July 2018 and the first default tariff cap took effect on 1 January 2019.

This is a change of circumstance that was unexpected at the time of the *Final Report* and Order. The CMA will need to consider the implications.

One implication is that the CMA may now have lost control of the timetable. At the time of its Order, the CMA was able to decide when the PPM tariff cap should cease, namely at the end of 2020 unless the CMA decided to extend it. Now, it seems implausible that the CMA could decide to remove the PPM tariff cap before the Government decides to remove the default tariff cap.

But this does not mean that the CMA has no influence on the duration of either cap. On the contrary, the CMA now needs to consider whether to facilitate the removal of both tariff caps. The answer to this question will depend on whether the CMA sides with the CMA(EMI) analysis or with the CMA(EMI) policy judgement.

Should the CMA now conclude that the CMA(EMI) analysis and calculation of detriment were essentially correct, but that, in retrospect, the CMA(EMI) policy judgement failed to appreciate the severity of the situation? If so, again in retrospect, the CMA(EMI) itself should perhaps have put in place a default tariff cap. And the CMA will have no doubt now about the continuation of the PPM tariff cap. It might even consider its formal extension to match the default tariff cap, in effect handing responsibility for the duration of the PPM tariff cap to Ofgem and the Secretary of State.

However, the wider implications of this answer are potentially severe. As will be suggested below, application of similar analyses to other consumer markets could well yield similarly large customer detriments in those markets and thereby require the CMA to propose the introduction of price caps in other markets. Indeed, the CMA is already moving in this direction. This could lead to widespread appeals against the CMA but could be popular with politicians and the media, at least in the short term.

The CMA might alternatively conclude that the CMA(EMI) was right to judge that a default tariff cap would undermine competition and result in worse outcomes for customers in the long run; but that the CMA(EMI) analysis understated the extent and prospect of competition in the domestic retail energy market; and that, as Deller et al suggested, its calculations (of £1.7bn average detriment and £2bn in 2015) overstated the customer detriment in this market. However, the media, Government and Parliament were so influenced by the headline figures of customer detriment that they were led to support and implement a measure that was quite inappropriate and indeed counterproductive.

The implications of this alternative conclusion are quite different. They suggest that, although it is no longer realistic to remove the PPM tariff cap immediately, the CMA should now take steps to ensure that the cap is indeed phased out by the end of 2020, and to facilitate the phasing out of the default tariff cap at that time too.

The following sections suggest reasons why the CMA should prefer this alternative conclusion, and how it might implement it.

3. Evidence of competition in the market since the Final Report 2016

This section summarises some key developments in the domestic retail energy market since the EMI commenced in late December 2014 and the *Final Report* was issued in June 2016. The next section looks specifically at the PPM sector.

It has become ever more apparent that the market is very competitive (at least, until the default tariff cap took effect). If this was not apparent at the time of the *Final Report*, it is now. The following summary (which does not purport to be comprehensive) draws on Ofgem's Retail Energy Market Charts and Indicators, Ofgem's *State of the Energy Market 2018*, and Cornwall Insight's *The Year of Living Dangerously*, An Energy Spectrum Review, January 2018, as well as several recent media and other reports.

The number of active licensed domestic energy suppliers increased from 22 in December 2014 to 38 in June 2016. It then leapt to 64 by June 2018. A new feature has been a significant growth in 'white label' suppliers. (Formerly there had been relatively few, notably retailers such as Sainsbury's and Marks & Spencer supplying energy provided by other licensed suppliers such as British Gas and SSE.)

The (annual average) rate of customer switching between suppliers continued to increase. It rose from about 12% in the first half of 2015 to just over 15% in the first half of 2016. It increased to just over 18% in the first half of 2018. This is in addition to about one third of customers of the Large suppliers that actively change their tariffs each year.

An increasing proportion of those customers switching supplier switched to suppliers other than the Big Six. In the first half of 2015 the proportion was 40%, in the first half of 2016 it was 50%. And in the six months to October 2018 it was 62%. That is, nearly two thirds of those customers that changed supplier, switched to a supplier other than a Big Six supplier.

Not surprisingly, then, the share of domestic customers with suppliers other than the Big Six continued to increase fast. The *Final Report* noted that "There has been a rapid expansion in the market shares of suppliers outside of the Six Large Energy Firms, from less than 1% at the beginning of the period [Q2 2011] to 13% in gas and electricity in the first quarter of 2016." (para 8.154) By Q2 2018 that share had risen to 24% and was still increasing. It is now about double the level observed in the *Final Report*.

The Six Large suppliers have thus lost nearly a quarter of their customers in just five years. More accurately, this is their net loss: they have lost many more than a quarter of their customers in this period, and have had to compete in the market to attract new customers to replace some of those they lost.

The *Final Report* observed that "This expansion [of market share of smaller suppliers] has led to falling levels of concentration in retail supply, with the HHI [Herfindahl-Hirschman Index] in gas falling from around 2,450 at the beginning of the period to around 1,900 in 2015 and the HHI in electricity falling from around 1,800 to its current level of around

1,450." (para 8.155) It explained that "Our market investigation guidance indicates that we are likely to regard any market with an HHI in excess of 2,000 as highly concentrated, and any market with an HHI in excess of 1,000 as concentrated." (fn 91) By this guidance, the gas market had gone from highly concentrated to concentrated, the electricity market remained concentrated.

This guidance is rather more severe than in the 2010 *Horizontal Merger Guidelines* of the US Department of Justice. These classify markets as Highly Concentrated (HHI above 2500), Moderately Concentrated (HHI between 1500 and 2500) and Unconcentrated (HHI below 1500).

In the event, the HHI continued to fall. In the domestic gas market, the HHI fell below the 1500 marker in mid-2018 and is currently around 1250. In the domestic electricity market the HHI had fallen below 1500 by the end of 2014 and was down to 1000 by the end of 2018. Thus, the domestic retail gas market would still be regarded as concentrated (just!) by the CMA guidelines but not by the US DoJ guidelines; the domestic retail electricity market is now unconcentrated according to both sets of guidelines.

The CMA's recent appraisal of the proposed SSE-nPower merger had to address this issue. "Ofgem said that it was concerned that the Merger, by increasing market concentration, could lead to price increases …" although Ofgem "could not determine with certainty that the [possible] price increases identified would be sufficient for the conclusion that the Merger could give rise to an SLC". (CMA 2018 para 9.7) The CMA concluded that "the merger is not likely to give rise to an SLC in relation to horizontal effects". (para 9.82) In simple terms, the CMA considered that concentration is no longer a problem in the domestic retail energy market.

Two caveats are in order here. The first is that the rates of entry and growth of small suppliers reflects in part a subsidy to them, in the form of exemption from social and environmental costs that have to be paid for by large and medium suppliers. As discussed later, this is presently estimated at just over £40 per year, though it was larger in previous years. The second caveat is that not all of these new entrants have survived the course, as now explained.

In retrospect, it is apparent that the EMI was conducted during a period of favorable wholesale energy prices. These prices rose shortly after the reference but then fell gently during the investigation.[1] Subsequently, wholesale prices increased, sometimes sharply, fell, then have since been rising again.[2]

Some suppliers were unable or unwilling to adjust their prices commensurately. Suppliers increasingly ran into payment difficulties: as of October 2016 5 suppliers were late making Renewable Obligation payments, in October 2017 16 suppliers were late and in October 2018 34 suppliers were late. In October 2018 the total shortfall in payments amounted to £58.6m. There was also a shortfall of £4.17m payments into the Feed-in Tariff levelisation scheme. These shortfalls have to be met by other suppliers (and ultimately by customers).

[1] The day-ahead wholesale gas price was 37.51p/therm in July 2014, rose to 54.84p in November 2014 then fell gradually to a low of 29.44p in April 2016. The day-ahead wholesale electricity price was £35.46/MWh in July 2014, rose to £48.43 in November 2014 then fell gradually to a low of £33.85 in February 2016.

[2] The wholesale gas price rose to 53.39p in January 2017, fell back to 34.84p in June 2017, then gradually increased to 62.83p in August 2018. The wholesale electricity price rose sharply to £67.54 in November 2016, fell back to £39.68 in June 2017, then gradually increased to £61.94 in August 2018.

Supplier failures reached unprecedented levels. Four suppliers left the market in 2017, no less than 13 suppliers exited in 2018, and one had already left after the first week of 2019. Some of these exiting suppliers were very small: Electraphase had under 100 customers, Gen4U about 500. Most were bigger: Snowdrop had about 6000 customers, USIO about 7000 customers, Future Energy about 10,000 customers. Affect with 20,000 customers and Together Energy with about 36,000 customers were even larger. Five other exiting suppliers were more substantial still: Iresa had about 90,000 customers, Extra Energy had 108,000 customers, GB Energy had 160,000 customers, Economy Energy had 235,000 customers and Spark had 290,000 customers. The total seems to be around 800,000 customers to date, mostly dual fuel, hence over 1.5 million customer accounts.

There was an active market for mergers and acquisitions: Co-operative Energy purchased Flow Energy (200,000 accounts) for £9.25m and Shell acquired First Utility (1,600,000 customer accounts) for £240m. A planned merger between SSE and nPower was called off. According to Cornwall Insight, "The decision not to pursue the merger was one sign of the tough times being experienced by suppliers of all sizes. Both SSE and Centrica issued profit warnings in the second half of the year as they struggled with rising wholesale prices and increased retail competition." (p 22)

As just noted, the CMA investigated and cleared the planned merger between SSE and nPower, concluding that "the proposed Merger may not be expected to result in a substantial lessening of competition". It reached this conclusion despite the fact that these were two of the Big Six suppliers, and the merged company would be the second-largest domestic supplier with an initial share of about 19% of the gas market and 23% of the electricity market. That such a merger could be approved without qualification surely suggests a very competitive market.

Various innovations appeared during the year. "These have included suppliers launching tariffs that give customers access to time-differentiated energy prices with app alerts when prices are low, as well as a new variable tariff that directly tracks wholesale energy costs, rather than charging customers an independent standard variable rate. The EV space continues to evolve rapidly, along with developments in home battery technologies. Several energy players have made moves into these new markets, including EDF, E.ON, ScottishPower, Green Energy, OVO and Octopus Energy to name a few. "Fully-integrated" packages are emerging that offer consumers low-carbon electricity, EV charging solutions and battery optimisation services." (Cornwall Insight p 26)

The above evidence suggests that the domestic retail energy market as a whole was very competitive until the introduction of the default tariff cap. Some may prefer to think of this as evidence that it was in fact competitive at the time of the EMI, others may prefer to consider it as evidence that the market has become more competitive than it was then. In either case, the evidence is strong that the market was competitive at the time the default tariff cap was introduced. And it calls into question the CMA(EMI) assessment of weak customer response and its calculations of customer detriment.

4. Competition and tariff caps in the PPM market since 2016

As expected, the PPM tariff cap has reduced competition in the PPM sector in certain respects. The *State of the energy market report 2018* reported that price dispersion narrowed during the first two periods of the price cap, although cheaper PPM deals were still available.

(p 33) It said that "Switching away from the largest suppliers has slowed down and the vast majority of PPM customers are on tariffs priced close to the cap." (p 34)

I found that in early October 2018 all but one of the Large and Medium suppliers were pricing at the level of the PPM tariff cap. This meant that, with the one exception, all the cheaper PPM deals were from Small suppliers that were effectively subsidised by virtue of their exemption from the social and environmental costs that larger suppliers had to meet, estimated to be worth over £40 per year for a dual fuel customer. Moreover, the extent of the cheaper PPM deals was much less than first appeared. (Stephen Littlechild, "Is there competition below the PPM tariff cap? What are the implications for policy?", University of Cambridge Energy Policy Research Group, 16 October 2018)

As to the reduction in PPM switching rate, one Big Six supplier reported a reduction of one third in the customers switching to it, another told me its reduction was one half. Ofgem confirms a reduction: "Between March 2017 and March 2018 (see Figure 2.15) the net PPM customer account losses for the six large suppliers have declined and the net gains for PPM specialist suppliers have reduced." (*State of the energy market report 2018*, p 34)

The numbers in Ofgem's Fig 2.15 are quite striking. In June quarter 2015 the six Large suppliers lost under 50,000 customers of both gas and electricity. The loss rate was accelerating steadily. In December quarter 2016 the Large suppliers lost over 100,000 gas customers and about 140,000 electricity customers. The imposition of the PPM tariff cap sharply reversed this trend. By March quarter 2018 the loss rates of Large suppliers were once again under 50,000 for each fuel.

The default tariff cap is likely to have similar effects, and on a larger scale.[3]

Nonetheless, the share of PPM customers with the Big Six has continued to decline and the share with new entrants has correspondingly increased. I have been shown estimates (based on Cornwall Market Share and Ofgem reported payment method proportions) that at end July 2014 some 7% of PPM customers were with entrants rather than Big Six suppliers, compared to 7.5% of credit customers. By end July 2016 – figures that would not have been available to the CMA(EMI) – the share of PPM customers with entrants had risen faster, to 17.2% compared to 14.5% of credit customers. And as of October 2018 the estimate is no less than 33.5% of PPM customers with entrants compared to 24.4% of credit customers.

Moreover, while no entrant supplier has yet reached the size of even the smallest of the Big Six suppliers in the market generally, this is not the case for the PPM market. I am told that Utilita is now the second largest supplier to PPM customers, having a larger share of such

[3] Already there are reports that "the biggest energy suppliers have grouped their tariffs at roughly the same price with only a £2 difference between the cheapest and most expensive big six variable tariffs. … the average tariff is £4 cheaper than the price cap … the difference between the average cheapest and the most expensive big six tariff is now £33, down from £150 in June 2017". ("Bulb accuses big six of using price cap as 'target not limit'", Katey Pigden, *Utility Week* 9 January 2019) Large supplier SSE has responded that this is not a Big Six issue: "In total, no less than 27 suppliers of all shapes and sizes have also set their prices within the same narrow range." (Guardian Business Telegraph, 14 January 2019.) Moreover, it is not just that the highest SVTs have been reduced to the level of the cap. Many suppliers have also increased their lower priced acquisition tariffs because at lower SVT prices it is no longer as profitable to attract new potential SVT customers. Ofgem earlier predicted that switching could reduce by up to 50%.

customers than five of the Big Six suppliers. And with its recent acquisitions of Spark and Economy Energy, Ovo might well now be the third largest supplier in the PPM market.

These data call into question the judgement of the CMA(EMI) that PPM customers were characterised by weaker customer response and that PPM competition was subject to problematic metering constraints. Perhaps PPM customers were, on average, different from credit customers in certain respects, and perhaps there were some technical constraints associated with metering. But these differences were evidently not material: they did not prevent a comparable level of switching by the time of the EMI, nor a faster rate of switching since then, even despite the adverse effect on switching of the PPM tariff cap. And they did not prevent new entrant suppliers taking on and beating the majority of Big Six suppliers in terms of PPM customer acquisition and retention.

5. Is PPM metering a problem?

The CMA(EMI) was concerned about PPM metering constraints. The CMA(EMI) Order provided for the PPM tariff cap to cease in December 2020 because at the time of the Order it was expected that the roll out of smart meters would be complete by then. The CMA *Invitation to Comment* says that the provision for a mid-term CMA review commencing in January 2019 could consider the implications of any faster or slower roll out. It notes the recent conclusion of the National Audit Office (NAO) that the number of smart meters installed by 2020 will fall materially short of that target.

But is this a problem? The *Final Report* thought that it would be.

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> "the technical constraints relative to tariff codes and higher metering costs do not apply to smart meters. It follows that suppliers may circumvent these issues by installing smart meters to existing customers or customers they acquire…. However, at present, only two independent suppliers – Ovo Energy and Utilita – offer smart meters as an acquisition strategy on a nationwide basis. (para 9.469) … we have not seen evidence that demonstrates that the rate of smart meter penetration in the prepayment segments as a whole is likely to change significantly in the near future. (para 9.471) We consider that this may particularly be a problem for some of the independent suppliers, as they may not find it financially viable to accelerate materially the roll-out of smart meters to the prepayment segments (para 9.472)… Considering that, as of Q4 2015, the independent suppliers only have, collectively, some 460,000 electricity and 410,000 gas prepayment customers, most of whom (roughly 60%) have been acquired by just one new entrant, it seems likely that many of the independent suppliers that offer competitively priced tariffs in the direct debit segments may not actively compete in the prepayment segments until a sufficient number of smart prepayment meters have been rolled out." (para 9.475)

In terms of smart meters generally, it seems that the BEIS business case envisaged about 50% rollout by June 2018, and actual roll-out was just over 25%. (NAO, *Rolling out smart meters*, HC 1680, 23 September 2018, Figure 12) But that was nonetheless about five times the roll-out of about 5% at the time in early 2016 when the *Final Report* was being put together.

As for the PPM sectors, Ofgem reports that "in 2017 the number of electricity and gas smart PPM meters increased by 59% and 55% respectively, compared to 2016". (*State of the energy market report 2018* p 36) There is then the increase from 2017 to 2018 to consider. I understand that there has been a significant switch to smart prepayment meters, and that the majority of new entrants offer smart meters to their PPM customers. The evidence mentioned

above shows that metering constraints have not prevented new entrants from growing even more rapidly in the PPM sector than in the market as a whole. On this basis, the technical metering constraints that the *Final Report* worried about no longer seem relevant in the PPM market. Consequently, the present expectation that there will not be 100% smart metering in the market as a whole by December 2020, as previously expected, is not a reason for extending the PPM tariff cap beyond December 2020.

6. The CMA Energy Market Investigation *Final Report*

Respondents to EMI consultations, including myself and former senior regulatory colleagues, submitted thoughts during the course of the investigation.[4] But it is only since the publication of the *Final Report* and the implementation of remedies that it is possible to assess the *Final Report* as a whole. The *Final Report* was a very significant achievement in terms of the breadth and depth of the work involved. Its analysis and remedies were widely (though not universally) welcomed as they pertained to the wholesale market, vertical integration, locational pricing, CfDs, RMR, settlement, codes, governance and so on. However, the analysis and remedies pertaining to the domestic retail market are a different matter and have proved controversial.

The relevant part of the *Final Report* may be summarised as follows. The CMA(EMI) considered that substantial numbers of customers were disengaged from retail energy markets. It based this assumption on their failure to move to lower priced tariffs that were available. The CMA(EMI) called this weak customer response. The *Final Report* concluded as follows.

> "160. Overall, our view is that the overarching feature of weak customer response gives suppliers a position of unilateral market power concerning their inactive customer base and that suppliers have the ability to exploit such a position through their pricing policies: through price discrimination by pricing their standard variable tariffs materially above a level that can be justified by cost differences from their non-standard tariffs; and/or by pricing above a level that is justified by the costs incurred in operating an efficient domestic retail supply business." (p 39)

Using its 'direct approach', the CMA(EMI) calculated that the average customer detriment averaged £1.4 billion per year over 2012-2015, and reached almost £2 billion in 2015. Using its 'indirect approach' the CMA(EMI) calculated that the detriment averaged £720m per year over the longer period 2007-2014.

In my view – again a view broadly shared by senior regulatory colleagues - the claim of "weak customer response" is not merited. The calculations of customer detriment are "artificial, misleading and inconsistent with previous competition policy"[5]. They are at best significantly overstated, if indeed there is any detriment at all. The discussion of price discrimination is misleading, particularly insofar as it assumes that the lowest prices in the market represent the competitive level.

[4] For example, Response by former GB energy regulators to CMA Provisional Decision on Remedies, 11 April 2016 (posted 21 April), and Supplementary submission on Provisional Decision on Remedies, 20 April 2016 (posted 21 April).

[5] Stephen Littlechild, Sir Callum McCarthy, Eileen Marshall, Stephen Smith and Clare Spottiswoode, Submission to BEIS Select Committee on Pre-legislative scrutiny of Draft Domestic Gas and Electricity (Tariff Cap) Bill, 17 November 2017 (published 10 Jan 2008).

For ease of reading, the rest of this section summarises the reasons for these critical conclusions. The arguments are set out in more detail in an Appendix to this paper, and in published papers.[6]

The CMA(EMI)'s main reason for assuming weak customer response was the existence of large unexploited gains from switching. However, this is not persuasive.

- For many customers these apparently unexploited gains are not as large in practice as the *Final Report* suggested.
- Many customers prefer to choose a supplier rather than keep choosing different tariffs, and it is not immediately obvious which other suppliers are better.
- Although average levels of service do not at present vary greatly by size of supplier, there are very great differences within each size range.
- Although present prices and savings can be observed, future prices in general cannot be known, and many suppliers have unexpectedly increased prices since the *Final Report*.
- Significant financial failures were not observed before or during the EMI but could have been a factor in customer decisions, and have been frequent among small suppliers since the *Final Report*.
- All these factors constitute a risk of choosing a different supplier and can explain why customers do not respond to price differences as rapidly as the CMA(EMI) considered they should do.
- The categories of vulnerable customer that the *Final Report* identified as less engaged seem generally less able to cope with the risks just noted, so it is not surprising that they have hitherto been less likely to change supplier.
- The competitive market addresses this problem by suppliers building reputations for reasonable prices, good customer service and financial reliability. This takes time but is already happening.
- Moreover new entrants in the domestic retail energy supply market are taking market share from previous incumbents about as fast as they have done in supermarkets. On that basis, competition seems comparably effective in the two markets.

In sum, there is no reason to argue that the energy market is characterised by weak customer response, any more than any other market is.

The CMA(EMI) used two methods to quantify the customer detriment associated with the alleged weak customer response. Its 'direct approach' compared actual prices with those that would obtain in a hypothetical competitive market – more precisely, the prices that would be charged to active customers by efficient suppliers in a steady state and earning a return equal to their cost of capital. It is not clear how this hypothetical equilibrium benchmark differs from "an idealized perfectly competitive market", use of which is explicitly precluded by the CMA's *Guidelines for market investigations*.

The CMA(EMI) 'indirect approach' began with a conventional excess profit calculation then added an estimate of inefficient cost, which on its own admission likely accounted for "a large part of the detriment we have observed". But variations in efficiency are normal in competitive markets. In previous market investigations, the CMA and its predecessors have typically not assumed that differences in efficiency constitute a customer detriment. In effect,

[6] E.g. Stephen Littlechild, "Competition, regulation and price controls in the GB retail energy market", *Utilities Policy*, 52, June 2018: 59-69.

by using the CMA(EMI) methodology, it would be possible to generate any level of customer detriment simply by making sufficiently strong assumptions about potential future efficiency.

The conventional excess profit element of the CMA(EMI) calculation averaged £303m per year over 2007-2014, in excess of the (disputed) cost of capital. If, instead, profits were benchmarked against the actual return in the market for Industrial and Commercial customers – which Ofgem regarded as so competitive as not to be worth investigating – and were also adjusted for difference in risk, then the excess profit would amount to some £170m per year. This is an order of magnitude lower than the CMA(EMI) calculations of £1.4bn and £2bn per year. It would amount to about £7 per dual fuel household per year, about half of one percent of an annual fuel bill of around £1200.

Whether even this figure reflects market power is doubtful, insofar as only two Big Six suppliers made significant profits in the period in question, and two of the other Big Six suppliers regularly made losses in this market. The more plausible conclusion is that prices on average were not above "the competitive level" over this period, and the alleged customer detriment figures are an artifact of very questionable and inappropriate calculations.

The final CMA(EMI) allegation is that the Big Six suppliers exercised market power by price discrimination. The *Final Report* gave scant recognition to the extensive and mounting literature containing economic analysis and evidence that price discrimination can, instead, be a means of competing. Indeed, it is so common that illustrating and explaining it has extended from the academic literature to become the stuff of best-sellers.[7]

It is now often claimed that there is a two-tier market where the lower prices reflect competition and the higher prices do not. This is misleading. In any real competitive market, there is always a range of prices. In practice, the lowest prices in the domestic retail energy market were and still are below what might be called a self-standing competitive level, for several reasons:

- Firms in competitive markets typically take different margins on different products, reflecting different strengths and elasticities of demand, in order to cover overhead costs, but the low margins and prices would not be viable on a self-standing basis.
- Many suppliers offer lower or below-cost prices on certain products as an introductory offer.
- Short-term products at lower prices impose higher transactions costs on customers that have to switch more frequently.
- The lowest prices by are typically subsidized prices by the amount of the social and environmental costs from which small suppliers are exempt, amounting to at least £40 on a dual fuel product.
- The low prices offered by several small suppliers proved not sustainable. Many such had to be increased, and over a dozen small suppliers made losses and were forced to leave the market.
- Although other small suppliers have survived, many are not yet making a profit.
- Some small suppliers do not intend to make a profit and are subsidized by City Councils.
- Quality of service varies greatly between suppliers and some of those suppliers with lowest prices have been reprimanded by Ofgem for not maintaining standards.

[7] E.g. Robert H Frank, *The Economic Naturalist, Why Economics Explains Almost Everything*, London: Virgin Books, 2008 (described as The No. 1 Sunday Times Bestseller) at Chapter 4, Why Some Buyers Pay More Than Others: The Economics of Discount Pricing.

7. The choice for the CMA between the CMA(EMI) analysis and recommendation

In considering whether and how to review its Prepayment Charges Restriction Order, the CMA faces a choice. It has to decide, either explicitly or by default, between the CMA(EMI) analysis and the CMA(EMI) majority recommendation not to impose a widespread tariff cap.

If the CMA endorses the analysis of the CMA(EMI), it can simply revise the calculation of the PPM tariff cap, or not, according to how convinced it is by the technical arguments put forward by suppliers. It can assume that the PPM tariff cap will continue at such a level until the end of 2020. It may well assume that it will not be politically acceptable to remove the PPM cap as long as the default tariff cap remains in place, which might be until 2023. So it could provide for the PPM tariff cap to be extended to match the life of the default tariff cap, and thereby in effect shift to Ofgem and the Government the responsibility for the decision about removing it.

Moreover, the CMA's recent investigation of a 'super-complaint' lodged by Citizens Advice seems reminiscent of the CMA(EMI) stance and its sympathy for targeted price caps. The CMA accepted the Citizens Advice concept of a 'loyalty penalty' whereby "longstanding customers can pay much more than new customers for the same services".

> "The CMA has looked at the 5 markets highlighted by the super-complaint – cash savings, mortgages, household insurance, mobile phone contracts and broadband – and found that there is a total loyalty penalty of around £4 billion a year in these markets. It also found that vulnerable people, including the elderly and those on a low income, may be more at risk of paying the loyalty penalty.…
>
> A number of recommendations are being made to regulators and government to help stop loyal consumers being ripped off. These include: …

- Firms should be publicly held to account for charging existing customers much more; regulators should publish the size of the loyalty penalty in key markets and for each supplier on a yearly basis.
- Targeted price caps to protect the people worst hit by the loyalty penalty, such as the vulnerable, where needed." (CMA, *Tackling the loyalty penalty, Response to a super-complaint made by Citizens Advice on 28 September 2018*, Press release, 19 Dec 2018)

The problem is where to stop. If a customer detriment of £1.4bn a year in the retail energy market justified a widespread default tariff cap for some 70 per cent of all domestic energy customers, rather than a targeted price cap, why doesn't a loyalty penalty of around £4bn a year in five other markets justify consideration of similarly widespread price caps on cash savings accounts, mortgages, household insurance, mobile phone contracts and broadband?

But that's only the start. The CMA itself goes on to conjecture that the loyalty penalty "is likely to be a much wider issue potentially arising in many other markets, for example in pay TV, roadside assistance, many other insurance markets [including car and health], pensions and other subscription services such as online gaming, software and magazines". (para 9) It also adds film and music screening, credit checking and gym membership. (para 2.24) But what about other forms of price differentiation in sectors such as rail and airlines, and for other consumer goods sold in the High Street and supermarkets? Indeed, why limit the analyses and restrictions to consumer goods - is there not much price dispersion in the goods and services provided to small businesses too, and even to large ones?

The 'loyalty penalty' is different from the CMA(EMI) customer detriment, insofar as the former quantifies a difference in prices rather than the net benefit to customers from equalizing prices. The estimates "should not be interpreted as a measure of the extent to which prices are currently too high overall". (para 4.8) Whether the media will appreciate the difference is not clear. And why the CMA(EMI) approach should not be applied in all these other sectors too is not addressed. Such an approach could yield large customer detriments that might be used to justify more extensive absolute or relative price controls. Simply assume that all higher cost producers are inefficient and therefore exercising market power, define a competitive price as equal to the cost or price of the lowest quartile producer, and impose a "transitional" price control accordingly. Affected suppliers might mount legal challenges, but consumers, politicians and the media will welcome the reductions in prices totalling hundreds of pounds a year. And they will be told that tough and widespread price caps not only protect customers but also simultaneously increase producer efficiency. What's not to like?

Admittedly this raises the problem of how to remove such price controls. But then, is there any need to remove them? Admittedly it is embarrassing for a regulator or Government to announce increases in prices when underlying costs increase. But that is not the CMA's problem, and is likely to be less serious with products whose prices are not so heavily influenced by world energy markets and government policy. And anyway, why should any consumer or elector benefitting from price controls support the removal of controls? Why take the risk of excessive prices, price discrimination and "loyalty penalties" returning? Why should competing firms want to reopen the competitive market once their own market shares have been cemented in by price caps that severely reduce the scope for price competition by rivals, and also reduce the incentive to engage in quality of service competition? Who is going to put weight on hypothetical calculations by a regulatory body or the CMA, to the effect that, despite an obvious reduction in competition as a result of the price controls, nonetheless the underlying conditions for effective competition are now in place as a result of other remedies the CMA has recommended, so all these beneficial price controls can be removed?

The consequence of this approach is thus that the CMA gradually gets sucked into identifying more customer detriments, inventing more intrusive remedies requiring more regulatory intervention, and recommending and/or implementing price controls across an increasing proportion of the UK economy. Such a pro-active approach might be consistent with the CMA's descent from the Office of Fair Trading, but is less consistent with the more deliberative and considered approach of its other ancestor the Competition Commission. The need for, and role of, the Competition Appeals Tribunal (CAT) would increase, as some foreshadowed at the time of the CMA's creation.[8] There is a risk that the CMA could come to be regarded as a competition and markets authority that cannot recognise a competitive market when it sees one. Of course, its reputation among a small group of professionals would initially be outweighed by its popularity in the media. The popular price controls

[8] E.g. "I would expect there to be quite strong pressure to moderate or control the CMA's power to impose intrusive remedies such as divestment in market cases; … I would expect many more strenuous challenges to the CMA's findings before the CAT covering not only the remedies, as is usually the case now, but the substance of the CMA's decision." Peter Freeman, "'Beware the Ides of March' – the Government's proposed competition reforms", *European Competition Journal*, 8 (December 2012): 563-572. "In the UK system, with … the task of holding a new, powerful, merged competition authority to account, the need for a specialised competition appeal tribunal, that is to say the CAT, appears to be stronger than ever." Peter Freeman, "Competition decision making and judicial control - the role of the specialised tribunal," Centre for Competition Policy UEA Annual conference, Norwich 6th/7th June 2013.

would prove difficult to remove. The UK would gradually become a more controlled economy. Ultimately, if competitive markets are claimed not to work without severe and extensive price controls, more people would question the case for the competitive market as opposed to government ownership.

8. The counter-argument

The argument against such a development is of course precisely the one advanced by the CMA(EMI) and cited earlier.

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

There should be no need to expound and repeat those arguments here. If the CMA does not understand and believe in them, who does?

However, this argument was overruled by the Government, and the media generally, because of the high levels of customer detriment cited by the CMA(EMI). Consequently, if the CMA attaches weight to the general argument against widespread price controls, it either has to find a better way of explaining why targeted price caps are justified but widespread price caps are not, despite the apparently high levels of customer detriment, or it will need to reconsider the CMA(EMI) calculations of customer detriment.

I and others argued during the EMI and subsequently that those calculations are not robust. There is substantial recent evidence of strong competition in the domestic retail energy sector, which may be interpreted either as evidence that competition was in fact strong during the EMI or has increased since then. The allegations of weak customer response ignored the risks to customers that are now more apparent following many financial failures. The 'direct approach' to calculating customer detriment, which used an equilibrium benchmark essentially equal to perfect competition, was inconsistent with the CMA *Guidelines on market investigations*. The 'indirect approach' to calculating customer detriment relied in a major way on a calculation of inefficiency that was inconsistent with previous CMA and Competition Commission practice.

The lowest prices observed in the market have been wrongly taken to be the "competitive level". In fact, they are below a self-standing competitive level for many reasons: they variously reflect the sharing of overhead costs in proportion to elasticity of demand, introductory discounts to attract longer-term customers, the effectively lower quality of a product that imposes higher transactions costs on customers, exemption from government environmental levies (hence forced cross-subsidy by larger suppliers), under-estimates by some suppliers as to the level of price required to survive in the market, policies of some suppliers to run at a loss in order to grow, policies of other suppliers (owned by local councils) not to make a profit and in some cases to subsidise costs, and in some cases substandard quality of service.

This is not to defend the large former incumbent suppliers, or to deny that there are new entrant suppliers that may have lower costs and offer lower prices with comparable or better quality of service records. Rather, it is to explain that what are taken to be "competitive prices" have in many cases and for many different reasons been effectively below "the competitive level". Consequently, the higher prices observed in the retail energy market

before the default tariff cap were not as extreme as commonly alleged, and indeed were part of the range of prices that characterise any competitive market.

Moreover, competition – viewed as "a process of rivalry between firms … seeking to win customers' business over time", as the CC 2003 *Guidelines* originally defined it - was working. As customers became better able to identify those entrants that reliably offered better prices and/or quality of service, they were increasingly moving away from the higher priced former incumbent suppliers to lower priced entrants. In the residential market as a whole, a quarter of customers have already moved and no less than a third of PPM customers. But as a result of the CMA(EMI) detriment calculations, two unjustified tariff caps have now been imposed, and at significantly below what might plausibly be regarded as a competitive level. Although they are bringing short-term price reductions to many customers, they are increasing prices to others, and also beginning to have the adverse consequences on competition that the CMA(EMI) itself identified. In particular, they are holding back the evolution of suppliers that customers prefer. They are also pre-empting the exploration and adoption of more targeted ways of protecting the most vulnerable customers without compromising the effective working of the competitive market.

9. Beginning the transition back to a competitive retail energy market

Both caps are presently scheduled to last until at least 2020, and there is provision for the default tariff cap to extend until 2023 unless Ofgem advises that the market is now effectively competitive and the Government accepts this argument. The adverse consequences of the tariff caps can be expected to continue and indeed increase over time, but there is a real risk that Ofgem and the Government of the day will find it difficult to remove them. The challenge for the CMA, therefore, is to find a way of facilitating the transition back to a competitive retail market by assisting the timely removal of the caps.

It does not seem realistic to seek to remove either tariff cap before the end of 2020. And it is probably not realistic to argue for removing the PPM tariff cap while the default tariff cap is still in effect. But it is feasible to aim at ensuring both caps can be removed at the end of 2020.

The major difficulty about removing either cap is the potentially substantial increase in prices after the removal of the cap - perhaps of the order of £75 on a dual fuel tariff of about £1200, since this was the promised saving associated with the caps, as discussed below. As noted earlier, who would propose and support a possible sudden increase of about £75 in the domestic energy bill? The answer suggested here is that the caps need to be phased out – that is, gradually increased in level to the point where finally removing the cap would not cause undue concern about further possible price increases nor concerted opposition.

How should this be done? The PPM tariff cap has so far been calculated and applied for four six-monthly periods from April 2017 to March 2019. It requires to be set for four subsequent periods. For simplicity I assume here that there is not sufficient time to modify the calculation (at least substantially) for the period April – September 2019, although the CMA could usefully begin to indicate its thinking. This leaves three periods (October 2019 – March 2020, April 2020 – September 2020 and October – December 2020, total 15 months) for which a revised basis might be used for setting the PPM tariff cap.

The CMA is presently considering whether to review the process by which the PPM cap is calculated. There are many elements in that calculation on which others will have a view and on which the CMA will decide. The present calculations are predicated on achieving what the

CMA(EMI) regarded as a competitive level of price. In the case of the PPM cap, this was reported to incorporate an average reduction of about £75 per dual fuel customer – this was the figure cited by Professor Cave in his minority report. But (in light of considerations set out earlier in this paper) it is questionable whether this is a realistic estimate of what might be called the competitive price level.

One possibility would be for the CMA to make a revised estimate of the future competitive level of PPM tariffs and to target that level in adjusting the PPM cap. But experience suggests that such estimation is difficult, controversial and time-consuming. Something simpler is required. The suggestion here is to phase out the initial £75 price reduction over the remaining period of the PPM tariff cap. This can be done by gradually adding to the Headroom component. More precisely,

- In the light of submissions made to it, the CMA should make such modifications as it deems appropriate to the present way in which it calculates the PPM tariff cap, and should make those calculations for the final three periods to December 2020.
- One of these modifications should be to the Headroom component, presently equal to £30 per dual fuel tariff. The CMA should add to that Headroom component an additional amount equal to £25 in the first period (October 2019 – March 2020), £50 in the second period (April 2020 – September 2020), and £75 in the third period (October – December 2020).

The intended effect of this proposal is that, at the end of December 2020, the PPM tariff cap will be approximately at the level that the average market price was when the cap was first applied, allowing for changes in underlying costs during the existence of the cap.

Three increments of £25 are proposed for simplicity, and consistency with present tariff cap periods. If such levels of increase are deemed too lumpy, an alternative would be to increase the Headroom component, and hence the cap, by an additional £5 per month over the final 15 months (from October 2019 to December 2020).

It might be argued that suppliers will have become more efficient over this period and will not need such a high level of price as the modified cap would embody. At some point this might indeed be the case. But if so it will be reflected in increasing competition below the cap, and greater customer switching, in the final months of the duration of the cap. This in turn will constitute increasing evidence that removal of the PPM tariff cap will not have adverse consequences for customers, and indeed will assist rather than hinder the further evolution of the competitive market.

It might also be argued that it would be inappropriate to raise the PPM tariff cap above the level of the default tariff cap, or to remove the PPM tariff cap while the default tariff cap is still in place. It is therefore necessary to consider the default tariff cap too.

10. A transition for the default tariff cap

The decision whether to remove the default tariff cap is for the Secretary of State, on the advice of Ofgem (or, strictly, of GEMA). But the level of the default tariff cap is a matter for Ofgem itself, according to the criteria laid down by the Act. The relevant conditions are the following.

> "1(6) The Authority must exercise its functions under this section with a view to protecting existing and future domestic customers who pay standard variable and default rates, and in so doing it must have regard to the following matters—

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

Section 1(2)(a) provides that Ofgem may modify the default tariff cap conditions from time to time. Section 2(1)(b) provides that Ofgem "must set out how the cap is to be calculated, and may make provision about assumptions required to be made in making the calculation". Section 2(3) requires that "Before making the first modifications under section 1 the Authority must, and before making any subsequent modifications under that section the Authority may, consult such persons as it considers appropriate on the methodology to be used for the purposes of the cap." Section 6(1) provides that Ofgem "must, at least once every 6 months while tariff cap conditions have effect, review the level at which the cap is set."

In setting the level of the default tariff cap for the first period, Ofgem adopted a methodology that enabled an average price reduction of the level mentioned in Parliamentary discussions. (Reportedly, had the cap been introduced at the time of those discussions, the average reduction would have been about £100, but subsequent increases in wholesale and other costs meant that the initial average reduction was about £75.)

However, the Act does not require Ofgem to use the same methodology in each period. It might be argued, for example, that Ofgem has initially adopted a methodology that puts a greater weight on present rather than future customers, and that it has had particular regard to incentives for suppliers to improve efficiency and less regard to the other three specified considerations. It would be open to Ofgem gradually to reverse these weightings as it reviews, over the period to end 2020, the level at which the cap is set.

That is, it would be open to Ofgem to take the view that a significant price reduction was appropriate when the default tariff cap was initially introduced. However, Ofgem could also consider that, over time, it would be appropriate gradually to put greater weight on longer term considerations, notably the interests of future customers, the incentives on suppliers to compete effectively and their ability to finance their licensed activities, and the incentives on customers to switch tariffs. In short, Ofgem could put increasingly greater weight on promoting competition and, to that end, on the timely removal of the default tariff cap. It could, for example, adopt the same or similar methodology as just proposed for transitioning the PPM tariff cap.

As noted, the level of the default tariff cap is a decision for Ofgem, not the CMA. But Ofgem's ability to consider and follow such a course would surely be strengthened by the CMA's stance on the PPM tariff cap. And the CMA's ability to consider and follow such a course would also be strengthened by Ofgem taking a similar stance. It would therefore be both possible and desirable for the CMA to begin to signal now that it wished to consider a policy to facilitate removal of the PPM tariff cap at the end of 2020.

Appendix: Critique of the CMA(EMI) Final Report

11. Weak customer response?

11.1 Money left on the table?

The CMA(EMI) *Final Report* argued that energy was a homogeneous good. "We would expect, therefore, that price would be the most important product characteristic to a customer in choosing a supplier and/or tariff." (para 8.11) The Big Six suppliers challenged this, arguing that non-price factors are also important. The CMA(EMI) rejected these arguments. It also found customer inactivity and lack of engagement, and substantial gains from switching that go unexploited. It characterised this as weak customer response, which it considered particularly the case for PPM customers.

How large are these allegedly unexploited gains from switching? In the CMA's scenario 5x, customers were assumed willing to change supplier, tariff and payment method. Over the period examined, the average such saving available to all dual fuel customers of the 6 Large energy firms was £164 (14% of the bill). (para 128) But some customers have a preference not to keep changing tariffs and suppliers; others are not able to interact only online or to pay by direct debit. Consider therefore the CMA's scenario 3b where customers can change supplier but not tariff type or payment method. Then the average saving to all dual fuel customers of the 6 large energy firms reduces from £164 to £65 (6% of the bill). (para 8.249 p 418) It is not so obvious that failing to switch indicates weak customer response.

It also turns out that the savings foregone by active customers are not so different from those foregone by less active ones.[9] This further calls into question the CMA(EMI) interpretation of the situation.

The CMA(EMI) view was essentially that customers did not behave as it expected them to behave, so customers got it wrong. An alternative interpretation (more consistent with a scientific approach) would be that empirical evidence rejected the CMA(EMI) initial hypothesis. Perhaps the plausibly available savings were not as great as the CMA(EMI) assumed, and/or price was not as important a product characteristic as it assumed, and/or non-price factors were more important than it assumed. Hence, customer response was not as weak as the CMA(EMI) was led to believe.

There is no doubt much more to be learned about customer response, but one fairly straightforward view is that, whereas the CMA(EMI) generally assumed that customers were choosing a tariff, many customers believe they are choosing a supplier. Most customers do not want to keep changing supplier. Hence a lower priced tariff is only attractive if customers believe that this is from a reliable supplier that will a) provide as good service as their present supplier and b) will not increase their tariff in future relative to their present supplier.

[9] For dual fuel customers of the Medium size suppliers – these are customers who have already demonstrated by switching supplier that they are actively engaged - the average potential savings are £143 (11% of bill) under scenario 5x and £72 (5% of bill) under scenario 3b. This compares to the above £164 (14%) under scenario 5x and £65 (6%) under scenario 3b for dual fuel customers of the Large suppliers. (CMA 2016 para 8.250 p 418) In other words, the active and engaged customers seem not very different from the allegedly less engaged ones, with respect to money left on the table.

11.2 Quality of service

Increasing evidence suggests that neither of these assumptions can be taken for granted. For example, billing accuracy averaged 94% for Large suppliers, 88% for Medium suppliers and 84% for Small suppliers. (*State of the energy market report 2018* Fig 2.13) For some customers, this might be an acceptable range of billing for a lower price tariff. Yet these differences are small compared to the range of accuracies within each category: 88.7 – 96.6% for Large suppliers, 69.8-95.9% for Medium suppliers and 55.0 - 99.7% for Small suppliers. How can a customer of a Large supplier (say), seeing a lower priced offer from a Small supplier, know whether that supplier has a billing accuracy of virtually 100% or scarcely half that level?

Of course, it is unlikely that any customer would make a decision based on billing accuracy alone. But there is similar variation in other aspects of quality of service, and Large suppliers are not always better. For example, Large suppliers averaged 6% missed appointments while Small suppliers averaged only 3% - but the performance across Small suppliers ranged from 0% to 22.8%.

Citizens Advice helpfully draws up a composite score for quality of service, weighting the above and other aspects. The median scores (doubled to give scores out of ten instead of five) are Large suppliers 7.6, Medium suppliers 7.2 and Small suppliers 5.5. Is this further evidence that it would be safer to stick with Large suppliers and avoid Small suppliers? Not quite: the scores for individual Large suppliers range from 8.8 down to 5.8 while the scores for individual Small suppliers range from 2.6 up to 9.4. Four Small suppliers have a Citizens Advice score that is better than or equal to the median Large Supplier, but eighteen have worse scores.

Arguably a customer could check on published quality of service measures, though in practice it is not clear that many do so. Helpfully, newspaper advice columns are increasingly recommending this.

Quality of service as measured by such objective parameters as Ofgem and Citizens Advice us is only part of the picture. What about the less measurable and more subjective aspects, such as the tone that customer service representatives take on the phone?

Trustpilot reflects entirely subjective rankings based on personal experience of customers who feel strongly enough to write in with a review and ranking. This gives a very different picture for Large suppliers. Medium and Small suppliers have mean and median scores of just over 7 out of 10 while Large suppliers have mean and median about 1 out of 10. Again there is variation: Large suppliers range from 2.4 down to 0.5, Small suppliers range from 9.5 down to 3.8.

Subjective views about each particular supplier vary widely. For the supplier with the lowest average score overall (a Large supplier), 95% of the 2526 Trustpilot reviews rated it Bad, but there were still 2% who rated it Excellent. For the supplier with the highest average score overall (a Small supplier), 87% of the 1823 reviews rated it Excellent, but there were still 1% who rated it Bad.

11.3 Uncertainty of future prices

Prices presently offered by competitors are observable, but what about future prices? There has been some concern about what is variously called acquisition pricing or Tease and

Squeeze tactics. Some suppliers – about half the suppliers in the market in October 2017 – offer lower prices for an initial period, after which a customer that does not actively switch supplier or tariff is put on to a higher Standard Variable Tariff or default tariff. (This is part of the rationale for the default tariff cap.)

To illustrate, on 15 October 2017, Economy Energy offered the second lowest fixed tariff in the market, at £815 (annual cost, dual fuel, London region). This was over £300 lower than the SVTs offered by three Big Six suppliers (BG and SSE at £1125, Eon at £1115). The CMA(EMI) could not understand why a rational customer would not switch supplier for gains of this magnitude. But Economy Energy's SVT was £1215, the highest in the market. A Big Six customer who switched to Economy Energy and was not aware of this, or who preferred not to switch again, would save £310 in the first year then pay £90 more each year than with BG or SSE, £100 more than with Eon. In the absence of tariff changes, such a BG or SSE customer would actually be £50 worse off after four years, an Eon customer would be £90 worse off.

Arguably a customer could check on a potential new supplier's SVT before switching to its low fixed tariff. But how can a customer know what tariff changes are in store over time in that SVT itself? And with the removal of Ofgem's simple tariffs policy, suppliers are increasingly competing via tariffs that are variable at a month's notice rather than via fixed tariffs. How will those tariffs look in a few months' time?

As already noted, the EMI took place over a relatively favourable period in terms of falling underlying wholesale costs, but customers have memories and know that this is not assured. During 2018 wholesale prices increased and some supplier price increases were dramatic – for example, Economy Energy increased its price by £311, from £811 to £1122. (Lookaftermybills.com) Five small suppliers announced price increases of 17% or more.

There were also repeated price increases by certain suppliers. Outfox the Market increased its price four times in four months from 2 August 2018 to 1 January 2009: by 6.4% then 7.4% then 7% then 14.4%, a total increase of £322 from £807 to £1129. (MSE News, 29 Nov 2018) Some Medium and Small suppliers that had conspicuously not engaged in Tease and Squeeze tactics and were previously regarded as offering consistently low prices nonetheless had to raise their prices. For example, Bulb increased its Vari-Fair tariff three times in little over six months from 28 April to 9 November 2018: by 3% then 5% then 11%, a total increase of £170 from £855 to £1025.

11.4 Possibility of financial failure

This may not have seemed an issue to the CMA(EMI), which witnessed no example of this during the EMI. But in this as in other markets, some customers no doubt felt that very low prices were too good to be true. And they were right. As noted above, since the *Final Report*, some 20 Small suppliers have been forced to leave the market. That's nearly equal to the total number of licensed domestic suppliers in existence at the start of the EMI.

Ofgem's policy has been to seek to protect customers from the consequences of choosing a financially weak supplier. This enables Ofgem to be seen to be riding to the rescue of customers when a supplier fails, and it has indeed so far protected those consumers from financial loss, and with minimal delay. But it does not protect those consumers from worry and inconvenience.

One consequence of the bail-out policy is that some costs fall on other suppliers and customers. This is increasingly causing concern. In addition, there are pressures on Ofgem to increase its supervision and control over new entrants, and over the pricing tactics and quality of service offered. This will increase the costs of regulation, again borne by customers generally. It will also tend, over time, towards the types of supplier and competition favoured by regulators, politicians and the media rather than favoured by customers themselves. The omens here are not good: the CMA(EMI) found that Ofgem's previous attempts to prescribe competitive and pricing tactics were not in the interests of competition and customers.

11.5 Vulnerable customers and reputation

Changing supplier thus offers the prospect of a lower tariff, at least initially, but there are nonetheless still significant potential costs and risks to customers, not least because they cannot know precisely what the future holds. It is therefore not surprising that many customers are cautious: they are right to be.

The *Final Report* notes that certain categories of customer are less engaged than others, notably "those who are elderly, live in social and rented housing or have relatively low levels of income or education". But is this surprising? Are they not categories of customer that would be less able to deal with these risks? In contrast, customers in their prime, able to afford their own homes and with relatively high levels of income and education, are better able to do so. The evidence indicates that customers are aware of this, in a way that the CMA(EMI) seemed unable to grasp.

Does this mean that vulnerable customers are doomed to pay higher prices for energy? No, because the market has a way to deal with these risks. Good energy suppliers – like good supermarkets - persuade customers to switch to them, and stay with them, by establishing a reputation - for reasonable prices, good customer service, and financial reliability. Ofgem, Citizens Advice, Trustpilot, the media and others, in their different ways, are enabling this to happen.

Establishing a reputation of course takes time. Broadly speaking it seems that the six Large suppliers have hitherto charged relatively high prices on their SVTs but on average have now attained high ratings on objective quality of service criteria - but they score remarkably low on subjective criteria. Those suppliers that Ofgem categorises as Medium – those that have attracted, kept and managed over 1% of customers (about half a million) – have now established good reputations in terms of prices and quality of service. At least one of the largest Small suppliers is on the verge of entering the Medium category, possibly with even higher reputation for both price and quality. In contrast several Small suppliers initially or at times offering the lowest prices have failed in terms of customer service and/or have been driven out of the market, and other Small suppliers have yet to prove their long-term viability.

11.6 Establishing reputations and increasing market share

Could it be argued that weak customer response and ineffective competition mean that it is taking an unreasonably long time to establish such reputations and to build significant new competitors in the domestic energy sector?

Compare the situation with supermarkets, one of the most competitive sectors in the UK. There have been two main recent new entrants. Aldi launched in Britain in 1990, Lidl in 1994, both having had at least a couple of decades of experience and large operations in

Germany and elsewhere. As of August 2017, Aldi and Lidl had taken market shares of 7% and 5.2%, respectively. (BBC News 22 August 2017, citing a report by Kantar Worldpanel) So these two experienced new entrants achieved an aggregate market share of some 12% after some 25 years.

The present seven Medium retail energy market suppliers generally had no previous experience or established positions in other retail energy markets. They entered the GB market over the period 2002 to 2015, with a median entry year of 2009.[10] In less than ten years from the median entry year they have taken an aggregate market share of 14% (per Ofgem's retail market indicators as of Q2 2018). Over the same period the multiplicity of Small suppliers have taken an additional 10% market share. And (in aggregate) both categories of entrant are still rapidly growing.

New entry has likely evolved further since then, and indeed is changing as this submission is being written. Ofgem has just announced (11 January 2019) that Ovo has acquired 235,000 customers from failed supplier Economy Energy, just weeks after it took on 290,000 customers from Spark Energy. Those two failed suppliers combined would represent about 1% of the market, taking Ovo alone to about 4% of the market. It is now the largest of the Medium suppliers, nearly half the size of the three smallest Big Six suppliers.

One of the other Small suppliers, Octopus which entered the market in 2016, serves over 400,000 homes and is growing fast. It already serves more electricity meters than Coop and Green Star Energy and seems likely to graduate from Small to Medium supplier soon. So the aggregate market share of eight Medium suppliers is soon likely to be around 16%.

Competition via new entry is thus comparably as effective in the domestic retail energy market as in supermarkets. Of course, in a new market where all suppliers except the customer's incumbent supplier are initially unknown and of unknown quality, customers are naturally and rightly cautious. But competition is just as capable, in the domestic retail energy market as in supermarkets, of enabling suppliers to build reputations that in turn will enable all customers to shop with confidence. It takes time but it was clearly already happening until the tariff caps were introduced.

12. CMA(EMI) calculations of customer detriment

12.1 The CMA(EMI) direct approach

The direct approach compared actual market prices against the CMA(EMI) benchmark calculation of competitive market prices. There is an immediate question whether this benchmark complied with the CMA's own *Guidelines for market investigations*. These *Guidelines* note that the market may be judged against a benchmark of a "well-functioning market", explained as "one that displays the beneficial aspects of competition … but not an idealized perfectly competitive market". (para 5.43 fn 22 p 192) But the conditions that the CMA(EMI) specified in the *Final Report* were quite idealized.

> "10.27 We have based our assessment on the principle that a competitive benchmark price in the domestic retail energy markets should fulfil the following criteria: *(a)* it should be reflective of the prices charged to active/engaged customers; *(b)* it should be reflective of the costs of an energy supplier which has reached an efficient scale (ie

[10] Utility Warehouse 2002, Utilita 2003, First Utility 2008, Ovo 2009, Cooperative Energy 2010, Green Star Energy 2013, Bulb 2015

a large supplier) and which is in a steady state (ie the supplier that is neither growing nor shrinking rapidly); and *(c)* it should generate revenue that is consistent with a normal return (equivalent to an average EBIT margin of 1.25%)." (p 605)

In consequence, the adjustments that the CMA(EMI) had to make to the actual costs of the comparator suppliers were very significant. The CMA(EMI) ended up comparing actual prices of the six large suppliers with the CMA(EMI)'s guess at what just two of the much smaller mid-tier suppliers would charge *if* they were not exempt from costly environmental obligations and *if* they had reached an efficient scale and *if* they were in a steady state and *if* they were not loss-making and *if* instead they were earning a normal return on capital. It was thus a comparison between actual prices and a hypothetical more efficient alternative. The CMA(EMI) acknowledged that its benchmark price was "a hypothetical construct, a 'supplier' that is a combination of the suppliers that we have identified as being the most competitive in the markets". (para 10.18 p 602)

How this hypothetical construct differed from "an idealized perfectly competitive market" is not clear. And if it was inappropriate for the CMA to use an idealized perfectly competitive market as a benchmark, why did not the same prohibition apply to the particular idealized hypothetical construct that the CMA(EMI) actually did use? And how, finally, is the concept of "a competitive benchmark price" (singular) "in a steady state" to be reconciled with the insistence in the CMA *Guidelines* (para 10) that "competition is a process of rivalry", involving "cutting prices, increasing output, improving quality or variety", which presumably implies differences between firms in efficiency, cost and price at any point in time, as well as differences and changes over time?

The CMA(EMI) final calculations remain unknown and therefore not capable of properly informed appraisal and challenge. During the investigation, Oxera, advising one of the large suppliers, argued that if the CMA(EMI) had made what Oxera considered proper adjustments to the costs of the mid-tier suppliers, this could more than wipe out the alleged customer detriment. (Oxera, *CMA Energy Market Investigation – Critique of CMA Consumer Detriment Analysis*, Prepared for Scottish Power, www.oxera.com, March 2017) In the event, the *Final Report* made significant further adjustments after the data room closed, so the final calculations could not be scrutinised by anyone and were not subject to consultation. These final adjustments were reportedly not negligible: Oxera estimated that they were about £1 billion – in other words, of the same order of magnitude as the claimed £1.4 billion detriment itself. But since their details were redacted in the *Final Report*, no one other than the CMA(EMI) panel and its staff knows or can know what the final calculations actually were.

12.2 The CMA(EMI) indirect approach

This approach to calculating customer detriment was unusual insofar as it added to the conventional excess profit calculation an estimate of inefficient cost. And this dominated the calculation. The CMA(EMI) itself pointed out that "A large part of the detriment we have observed in the form of high prices is likely due to inefficiency rather than excess profits, such that if we were to eliminate the entirety of the detriment we have observed through a price cap it would create substantial losses for the sector as a whole". (para 11.90) Perhaps for that reason, the CMA and its predecessors (and its counterparts in other countries) have not generally adopted such an approach.

Variations in cost are entirely normal in competitive markets, and costs themselves are constantly changing.[11] It is therefore unusual to regard cost differences as evidence of a lack of competition. There seem to be only two previous calculations of inefficient cost by the Competition Commission (CC), and they did not play a significant role in its analyses. In *Supermarkets* (2000), the CC decided not to adjust for inefficiency because the inefficient companies made losses, hence shareholders rather than customers bore the cost. The CMA(EMI) did not follow this precedent even though the two least efficient large suppliers routinely made losses. In *SME Banking* (2002) the CC initially decided to add inefficient costs to its estimate of excess profits, but on further consideration adopted significantly higher cost-income benchmarks, similar to the average of the four largest banks, and applied a cost-income adjustment to only one of the six major banks examined. It did so "in order to allow for other factors that influence the ratios". The CMA(EMI) did not make any such allowance. In the CMA's recent re-investigation of some SME banking issues (CMA 2016), the question of cost efficiency and possible efficiency adjustments did not feature. The CMA(EMI) approach thus seems inconsistent with previous practice.

The CMA(EMI) more conventional calculation of excess profit (profit above the assumed cost of capital) averaged £303m per year over 2007-2014. The assumed cost of capital was (not surprisingly) disputed by the major suppliers. Suppose, instead, that the CMA(EMI) had taken as its benchmark the actual return obtaining in the market for Industrial and Commercial customers - a market that Ofgem and the CMA(EMI) regarded as so competitive as not to require investigation - and had adjusted for what Ofgem calculated to be the difference in risk between the two markets. Then the alleged excess profit would be reduced by nearly a half to about £170m per year. This is an order of magnitude less than the much-cited customer detriment figures of £1.4 billion and £2 billion per year. It would correspond to under £7 per dual fuel household per year, about half of one percent of an average annual fuel bill of around £1200. It is not a level of detriment that would lead to concern, and certainly would not justify a tariff cap on the majority of customers, or even on PPM customers.

Whether even this level of average profit reflects market power is doubtful. In an earlier investigation, the CC observed that excess profits would not indicate a failure of competition if they were specific to a particular firm. [12] In the domestic retail energy market, two of the six large energy suppliers regularly made losses over the 2008-2014 period that the CMA(EMI) examined, and two other suppliers made a very low return. This casts doubt on any suggestion that the profits of the remaining two large suppliers in the market (let alone all suppliers) reflect market power. They are more accurately characterised as producer surplus, reflecting greater efficiency and lower costs than the other large suppliers. This is entirely consistent with a competitive market.[13] The more plausible conclusion is that average price in

[11] There is no such thing as "the efficient level of cost", a concept unfortunately still promoted by Ofgem.

[12] C.f. "6.152 In order to be indicative of a failure of competition, profits in excess of the cost of capital must be persistent, ie there must have been sufficient time for a competitive response (entry or expansion) to have occurred, rather than being just a short-lived or temporary situation relative to the life of the investment. Profits should also not be specific to a particular firm; we would expect that suppliers who are particularly innovative or efficient will realize higher profits than others in the same market." CC, *Rolling Stock Leasing* 2009

[13] One of the large suppliers cited a publication coauthored by the CMA's present Chief Economist that made precisely this point. "The [basic competitive] theory predicts that the marginal firm in long-run equilibrium earns zero economic profits, but firms with lower costs will earn positive economic profits." (Lind, R and Walker, M, 'The (mis)use of profitability analysis in competition law cases', CRA [Charles Rivers Associates] *Competition Policy Discussion Papers* 9, December 2003, p 4)

the market over this period was not above "the competitive level", and if anything could have been below it.

13. Price discrimination and the two-tier market

The *Final Report* claimed that weak customer response gives suppliers unilateral market power which they can exercise through price discrimination, "by pricing their standard variable tariffs materially above a level that can be justified by cost differences from their non-standard tariffs".

Insofar as the mark-up over cost on the Large suppliers' SVTs was larger than the mark-up on their fixed tariffs, this constituted price discrimination. But was it simply an exercise of unilateral market power? Or was it rather a means of competing? Was it not a means of attracting new customers and keeping existing ones, by offering lower prices on some products or to some customers when it was not viable for those suppliers to offer such low prices to all?

The simple evidence on supplier profit noted above casts doubt on the existence of unilateral market power in the first place. If they were able to exercise such power by price discrimination and pricing above cost, why were two large suppliers generally making losses throughout the period studied?

There is now widespread analysis and evidence in the economic literature to the effect that price discrimination can be a means of competing – and indeed, that suppliers may be forced by the strength of competition to engage in price discrimination. It is therefore surprising and disappointing to find the CMA(EMI) simply assuming that observed price differentials reflect the exercise of unilateral market power. This, after all, was the elementary mistake that Ofgem made in imposing its non-discrimination condition in 2009 – a mistake that leading regulatory economists (including a member of the CC and a former Director General of the OFT) pointed out at the time, and whose critical views the CMA(EMI) essentially endorsed.[14] Indeed, the *Final Report* recommended that Ofgem withdraw the prohibition on discriminatory discounts implicit in its simple tariffs policy.[15]

A consequence of the CMA(EMI) analysis is the suggestion that the domestic retail energy market is a two-tier market, with a lower price for active customers and a higher price for inactive customers. This is somewhat of a simplification, insofar as there is of course a whole spectrum of prices in this as in any competitive market, not just two prices.

More worrying is the associated suggestion that competition works for active customers, and their lower price is "the competitive price", but that competition does not work for less active customers and their higher price reflects the exploitation of market power by the Large suppliers.

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[14] The *Final Report* referred to research (Waddams Price, C and M Zhu, 'Non-Discrimination Clauses: Their Effect on GB Retail Energy Prices', *The Energy Journal*, 37(2) 2016: 111-132) which "found that there was less-effective rivalry between the regional incumbents and large regional competitors following its introduction" (fn 36). It noted that "when Ofgem prohibited suppliers from offering out-of-area discounts for new customers, the effect was to increase prices for out-of-area customers and reduce the strength of competition." (para 14.44)

[15] Ofgem required that suppliers should make available any discount on a uniform basis to all customers. The *Final Report* recommended removing this "because the effect of these restrictions is to reduce the competitive pressure that any supplier exerts on its rivals and therefore to reduce the pressure suppliers face to offer competitive prices to attract or retain customers (just as it is now recognised that the prohibition of regional price differentials adversely affected the extent of price competition between the Six Large Energy Firms in setting prices of SVTs". (para 12.386)

Some suppliers undoubtedly have lower costs than other suppliers and are undoubtedly pricing lower than other suppliers. There is also no doubt that more active customers have generally paid lower prices, hitherto mainly for short-period fixed tariffs, than less active customers have paid for staying on SVTs.

However, the characterisation of the fixed tariff market as having a competitive level of price, and the SVT market as being non-competitive and reflecting market power, is misleading. There are numerous reasons why the lowest prices in the market do not represent what might be called a self-standing competitive price level.

First, although SVTs and fixed tariffs are separate products, suppliers incur certain overhead or common costs across all customers. In a competitive market, suppliers need to recover their overhead costs according to the strength and elasticity of demand for each product. A higher margin on SVTs than on fixed tariffs is not inconsistent with competition. By the same token, the lower margin on fixed tariffs is only possible because of the existence of the higher margin on SVTs. In a fully competitive wholesale market, a generating plant might get ten times the price for supplying energy at peak rather than off-peak, but this does not mean that the off-peak price is the competitive price and the peak price reflects exploitation by certain generators.

Second, as noted earlier, many suppliers have offered low fixed price tariffs as an "introductory offer" in the hope that a proportion of these customers will (either consciously or by default) stay on to that supplier's higher SVT. In setting its prices for fixed term contracts the supplier will take this expected subsequent higher return into account. So the prices of fixed tariffs do not themselves represent the self-standing level of competitive prices. They are consciously priced at a *discount* to a self-standing competitive level. They no more indicate the competitive price level than a free month's initial subscription to a magazine implies that the competitive price for magazines is zero.

Third, lower priced tariffs, which until recently were generally fixed-price fixed-period tariffs, impose higher transactions costs on customers than SVTs. Over time, the customer must repeatedly consider which new tariff to choose when the existing one expires, and whether the present supplier still offers value for money, and if not which supplier and tariff would be preferable. For some customers these challenges are particularly daunting, for others the savings ares not worth incurring the costs. In both cases the perceived quality of the low price product is inferior to that of higher priced alternatives.

Fourth, the lowest tariff prices are typically subsidised prices offered by Small suppliers that are exempt from the social and environmental costs levied on the Large and Medium suppliers. The CMA noted that Ofgem estimated this exemption at £71 in the year to 31 March 2016. (fn 109 p 984) More recently it seems to have been just over £40. So the small suppliers and their low fixed prices are cross-subsidised by the larger suppliers out of their higher SVT prices which are paid for by their less active customers. The CMA(EMI) took the view that the exemptions were not likely to be market-distorting. This judgement is perhaps difficult to defend given the remarkably rapid growth of new entrants at the expense of incumbent suppliers. But for present purposes the point is that the CMA(EMI) failed to recognise that the subsidy distorted the perception of competitive market price.

Fifth, the low prices offered by numerous Small suppliers have evidently proved not to be sustainable. Over a dozen small suppliers simply misjudged what price they needed to survive, and had to leave the market having made losses.

Sixth, many – perhaps most - of those Small and even Medium suppliers that have so far survived and that seem to have been better managed do not yet seem to be running at a profit. They are consciously running loss-making businesses in order to grow. For example, losses at Bulb energy supplier increased from £2.1m in the year to March 2017 to £23.7m in the year to March 2018. (*The Times* Dec 20 2018 p 47)[16]

Seventh, some Small suppliers do not intend to be profit-making and are in effect subsidised by local authorities. For example, Robin Hood Energy is owned by Nottingham City Council, it operates on a not-for-profit basis, and its directors are unpaid. It was set up in 2015, reported losses of £2.5m in its first year of trading, £7.6m in its second year and a small profit of £202,000 in its third year. In December 2018 the Council agreed a further loan of £5.5m, in addition to its existing £20m loan. (Robin Hood Energy blog, 21 Dec 2018) Bristol Energy, also set up in 2015, by Bristol City Council, posted a loss of £11.1m in the year to March 2018. The Council has reportedly invested £17.3m into the company to date. (Bristol Post 29 Jan 2018) The company presently does not aim to be profitable until 2021.

Eighth, quality of service varies greatly, between suppliers and over time. Some suppliers – including some of the lowest price ones – have been unable to cope with growth and have let standards slip significantly. On occasion Ofgem has forbidden some suppliers to accept new customers until acceptable standards of service are met (the most recent case being Economy Energy in December 2018).

For all these reasons, the public has been given an unrealistic impression of the competitive level of price, and has been led to believe that SVTs are significantly above the competitive level. Hence the widespread impression that the market is less competitive than it actually is, and that the less active SVT customers are being exploited. And hence the belief that price control is needed to bring SVTs down to the "competitive level", when in fact it will put them below that level.

Unfortunately, the concept of the two-tier market continues to be promoted by Ofgem and BEIS. "Without retail market change … customers may continue to be at risk in a two-tier market. Lack of competition means incumbents could cement their position using their high-profit customers."[17] This is the opposite of the actual situation. Until the imposition of the tariff caps, there was no lack of competition, customers were not at risk, incumbents were not able to "cement their position" and indeed were steadily losing market share to new entrants. In contrast, as noted above, there is now evidence that the PPM tariff cap has already reduced competition and begun to cement the position of the PPM incumbents, and that the default tariff cap is already beginning to do the same on a larger scale.

Postscript: A short note on PPM market shares

18 January 2019

In my Response of 17 January I reported estimates (section 4) that 33.5% of PPM customers might now be with entrants and that Ovo might now have grown to be the third largest PPM supplier.

[16] According to one small supplier, "it took First Utility and Co-Op Energy 4 years, Bristol Energy 5 years [to achieve break-even] and Ovo Energy are still yet to achieve break-even despite being set-up back in 2009". (Robin Hood Energy.co.uk/whatayear)
[17] Ofgem BEIS Independent Suppliers Forum, 7 December 2018, slide 121.

Further discussion with informed parties suggests slightly greater uncertainty here. The percentage of PPM customers with entrants might be in the range 30 – 34%. This is still greater than the entrants' 25% share in the retail market as a whole, but implies that the PPM tariff cap may have had a greater adverse effect on competition than hitherto assumed. Ovo, for its part, might even have overtaken Utilita to become the second rather than third largest PPM supplier. But either way, two entrants rather than one have now overtaken five of the six former incumbent suppliers in the PPM market.

Given the importance of assessing the effectiveness of competition in the PPM market, it would seem appropriate for Ofgem to gather and publish similar data on PPM market shares as it does for the retail market as a whole.

Regardless of the detailed percentages, however, one conclusion is clear. The PPM tariff cap was predicated on the assumptions that weak customer response is a more significant problem among PPM customers than in the retail market as a whole, and that metering constraints restricted PPM competition. Both these assumptions are now clearly incorrect. Unfortunately, on the basis of the CMA(EMI) analysis and PPM tariff cap, Parliament was led to impose a wideranging default tariff cap, which could possibly last for a much longer period. As explained, I hope the CMA can now do something to remedy this situation.