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**Retail Lessons for New Zealand from the
UK Energy Market Investigation
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Summary

This paper contains a summary of the conduct and aftermath of the investigation into retail household energy market completed in June 2016 by the UK Competition and Markets Authority (CMA).

The inquiry found that the market exhibited several features which had an adverse effect on competition. Thus:

- households were divided between about one third which actively engaged in search and switching behaviour and benefited from lower 'competitive' tariffs, while about two thirds were disengaged and paid higher tariffs; the latter group were victims of unilateral market power wielded by their individual large supplier*
- the difference in tariffs amounted, at a peak, to about £250-300 per year on an annual payment of about £1000; the total detriment to households was estimated to be £1.4 billion per year;*
- some microbusinesses also paid excessive charges;*

By way of remedies, the CMA favoured measures to promote engagement by customers, and the elimination of regulatory provisions which curtailed competition. The CMA also imposed a temporary 'safeguard' cap on the tariffs of a group of customers which had to pay in advance for their energy; this was in response to the limited number of suppliers competing for their business. A wider price cap introduced as an antidote to customer disengagement was rejected.

These decisions mirror wider debates about the respective roles of demand-side and price control measures in energy and other markets, in the presence of disengaged customers. The paper examines the issues involved in this debate. The CMA chose demand-side remedies because it had confidence that they would work and thought it likely that a price cap would discourage engagement.

In the two years since the review was concluded, engagement (in the form of supplier switching) has increased, and the share of customers on the higher tariff fell from 64% in April 2016 to 57% in October 2017. Over this period the gap between the cheapest tariff and the average tariff paid by disengaged customers has remained at about £300 per year.

In response to these facts, the UK Government has brought forward legislation requiring Ofgem, the sectoral regulator, to impose a temporary price cap on all tariffs to which customers can be defaulted if they do not choose an alternative. Subject to Parliamentary approval, this will take effect in late 2018.

What lessons might this hold for New Zealand?

- *In process terms, the NZ inquiry can (compared with the UK one) be more agile, and more quickly identify and concentrate on key issues such as customer engagement;*
- *In relation to household and SME retail prices (the subject of this paper), it is helpful if the inquiry team can produce (and publish) a reliable snapshot of the shape of the markets, including levels and differences in prices, and search and switching behaviour. A comprehensive customer survey can be very helpful in this regard;*
- *There are recognised characteristics of retail energy (and some other) markets which make it likely that some customers will be disengaged and subject to price discrimination by their supplier; vulnerable customers may be particularly prone to this danger;*
- *UK retail energy markets differ from NZ ones in many ways, but should the evidence support a disengagement finding in NZ, the inquiry should be able to identify a set of remedies which addresses the problem; these may include demand-side and more intrusive supply-side measures;*
- *The balance of such a package may depend on the scale (and hence the urgency) of any correction required, and upon the government's approach to regulatory interventions in general;*

1. Introduction

This paper sets out some of the lessons relating to household and small firm retail energy markets which flow from the Competition and Market Authority's 2014-2016 UK energy market investigation and its aftermath.¹

The paper is organised in the following sections:

1. How the retail household energy market worked in Great Britain
2. The customer disengagement theory of harm
3. How was customer detriment in the market estimated?
4. The household market remedy debate
5. Small firm and microbusiness tariffs
6. What happened after the CMA review was completed
7. Some possible lessons for the New Zealand inquiry.

This is followed by an account of some of the customer survey data collected as part of the CMA investigation.

1. How the retail household energy market worked in Great Britain

Under UK competition law, a market investigation is required to establish if there are features of the market or markets under investigation which have the consequence of exercising an adverse effect on competition. The adverse effect on competition can be associated with conduct of a firm or firms, but it need not be. Unlike other tools available under UK (and European) competition law which are expressly directed at preventing abuse of market power by an individually identified dominant firm or firms, in UK market investigations it is not necessary first to show that the firms in question hold (individually or via concerted or parallel conduct) a dominant position in the market. However, such abuse of market power can be an adverse effect on competition.

¹ The CMA report was published in June 2016, in the form of an 80-page summary ("CMA Summary") and a 1460-page final report ("CMA Final Report"), with about 5000 pages of appendices.

To understand what follows, it is helpful to know a little about the development of competition in UK retail household energy markets.² Initially they were local retail monopolies in electricity and a national monopoly in gas. Beginning in 1998, competition was progressively allowed, region by region, subject to price controls on the historic monopolist, which contained a degree of headroom over the cost of retailing, in order to encourage new entry and search and switching by customers. The price caps were all finally lifted by 2002.

These new circumstances allowed both existing regional firms and new entrants to seek new customers, and also allowed electricity and gas to be marketed together in ‘dual fuel’ offerings. Thus the former gas monopolist, British Gas, could also begin to sell electricity.

Contracts were initially based on evergreen principles, with no end date (and no exit fee). The supplier might change the tariff from time to time. They became known as standard variable tariffs or SVTs. Later fixed term and capped tariffs were introduced as alternatives, with the rider that if a fixed term tariff expired and were not replaced, the household would be placed on the SVT.

At the same time, mergers took place among electricity distribution and retail companies, so that the legacy monopolists were aggregated in six companies – five derived from the electricity side, one British Gas. The companies, known popularly as ‘the big 6’,³ dominated retail markets. New entrants found it hard to make headway, and the volatile prices of wholesale energy in the following years thinned their ranks.

As a result, by 2012, the combined market share of the SLEFs was 98%, new entrants having the remaining 2%. The majority of the SLEFs customers - about 70% - were on standard variable tariffs. Many of those on SVTs had never switched, and a few others would have defaulted to the SVT when they failed to renew their fixed term tariff. New entrants’ household customers were, in contrast, overwhelmingly on fixed terms tariffs. As the new entrants’ share grew in subsequent years to 20% or more, these were overwhelmingly low margin ‘searchers and switchers’.

² See further Catherine Waddams Price (2018) Back to the Future? Regulating Residential Energy Markets, *International Journal of the Economics of Business*, 25:1, 147-155, available at

https://ueaeprints.uea.ac.uk/66445/1/Published_manuscript.pdf

³ In the CMA report, they are given the more neutral name of the ‘six large energy firms’, or SLEFs, which is used here.

A further development concerning competition among the SLEFs deserves mention. Apart from British Gas, which had a national franchise for the reason noted above, the five other SLEFs inherited strong positions in areas where they were the historic monopolists, and had very weak ones elsewhere. They reacted by offering discounted prices to out of area customers. The regulator Ofgem took the view that this was unfair, and forbade it from 2009. This predictably softened price rivalry among the SLEFs (and offered them an object lesson in the mutual benefits of foregoing competition). This rule was withdrawn in 2014, but its effect seems to have lingered. Then in 2010, in the interest of simplifying customer choice, Ofgem introduced rules which limited to four the number of tariffs any supplier could charge. This had the effect of eliminating certain cheaper SVT tariffs. The CMA found that this restricted competition, and it was withdrawn.

2. The customer disengagement theory of harm.

Based on the data of the survey, the CMA investigated a theory of harm under which certain firms exercised unilateral market power over certain groups of consumers. By dint of this market power, each firm was able to charge excessive prices on a discriminatory basis to a particular category of consumers – those who were disengaged from the market.

Household retail energy tariffs vary by region and by contract in many ways, for different reasons:

- The costs which retailers pay for transmission and distribution vary in different regions; since these differences apply uniformly to all energy purchases in the region, they are likely to be reflected in retail prices;
- The costs of serving customers paying their bills in different ways vary, as a result of different transaction costs and bad debt rates. Lowest cost are direct debit customers; then come ‘standard credit’ customers who pay by cash or cheque on receipt of (usually quarterly) bills; then come pre-payment customers. Standard credit customers usually pay £75-80 per year more than direct debit customers. Pre-payment customers (who pay for their electricity and gas in advance) pay the most.⁴
- Then there is the choice between SVT and fixed term contracts. Most fixed term contracts are for one or two years, at prices below

⁴ These tariffs are not observed in many countries. They are used predominantly by customers in transit or by those with poor credit ratings.

the SVT rate. But some may be for much longer, and be above the SVT rate.

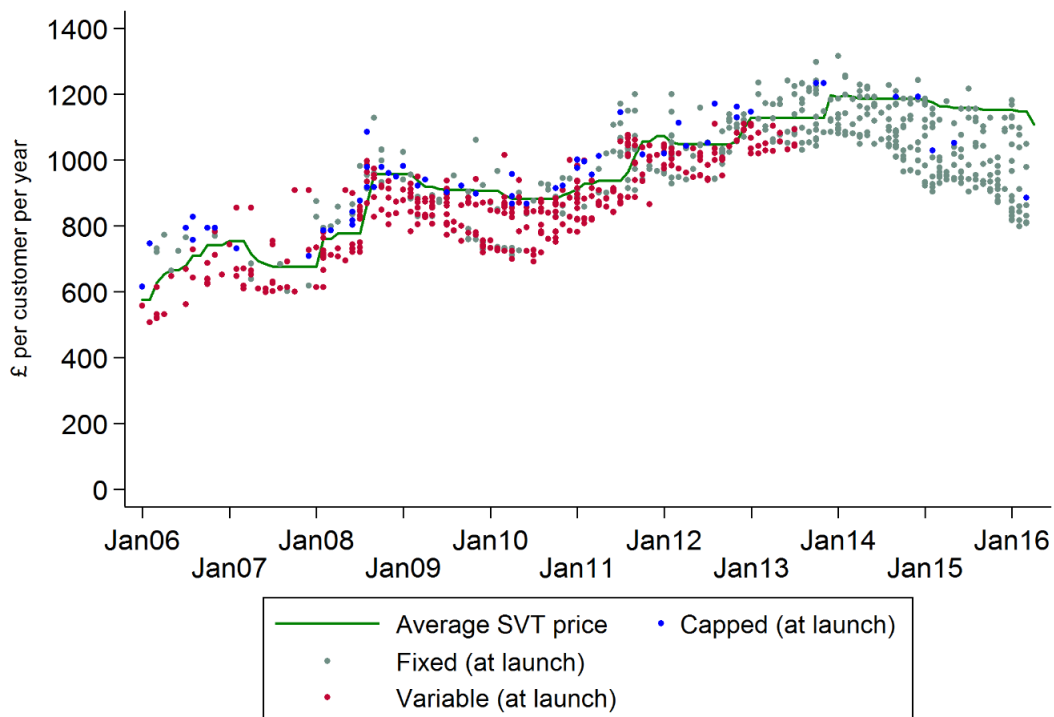
The theory of harm which the CMA explored was that the household energy market was what Ofgem later described as a two-tier market. The competitive tier included households which searched, usually annually, for a new contract – often employing price comparison websites. Such web sites were obliged to list all tariffs, but by paying the website a commission, a retailer could ensure that a customer could get directly from the PCW to its own site, thus facilitating a purchase.⁵

Disengaged households were generally on the evergreen SVT tariff, either because they had never made a positive choice, or because they had defaulted to the SVT at the expiry of a fixed term tariff.

The CMA assembled a great deal of evidence on the relationship between the various tariffs. Figure 1 shows the relationship between the average SVTs of the SLEFs and the other contracts which they offered, falling into the categories of capped tariffs (which could not rise above a pre-specified level), fixed tariffs (usually for one year) or variable tariffs.

⁵ This ‘whole of market’ rule was subsequently abated following a recommendation in the CMA report.

Figure 1: Average SVTs and non-standard tariffs offered by the Six Large Energy firms (based on an annual bill for a dual fuel, direct debit, typical consumption customer) (Source: CMA, Summary p. 25)



Based on typical domestic consumption of 3200kwh/year for electricity and 13500kwh/year for gas.

The figure shows an upward trend in average SVT tariffs, in a succession of steps from about 2012. The ‘steps’ reflect the fact that the SLEFs raised their SVTs fairly infrequently, but all at about the same time.

It is apparent that the balance changed over time among the non-standard tariffs, with the capped (blue) and non-standard variable (red) tariffs giving way to fixed term (green) tariffs in mid- 2013. This is probably a response by the SLEFs to the almost exclusively fixed term offering of their rivals, which increased their market share from 2% in 2012 to 15% in 2016. In other words the battle ground in the competitive tier of the market, between the SLEFs and the larger entrants, christened the mid-tier suppliers, became fixed term contracts.

A further noticeable feature of the figure is the widening gap in the period after 2013 between the SVT and fixed-term offerings of the SLEFs themselves. It should be borne in mind that the SLEFs expect some of their fixed period customers to default to their more expensive SVT contract, so that profits from such subsequent harvesting of acquired

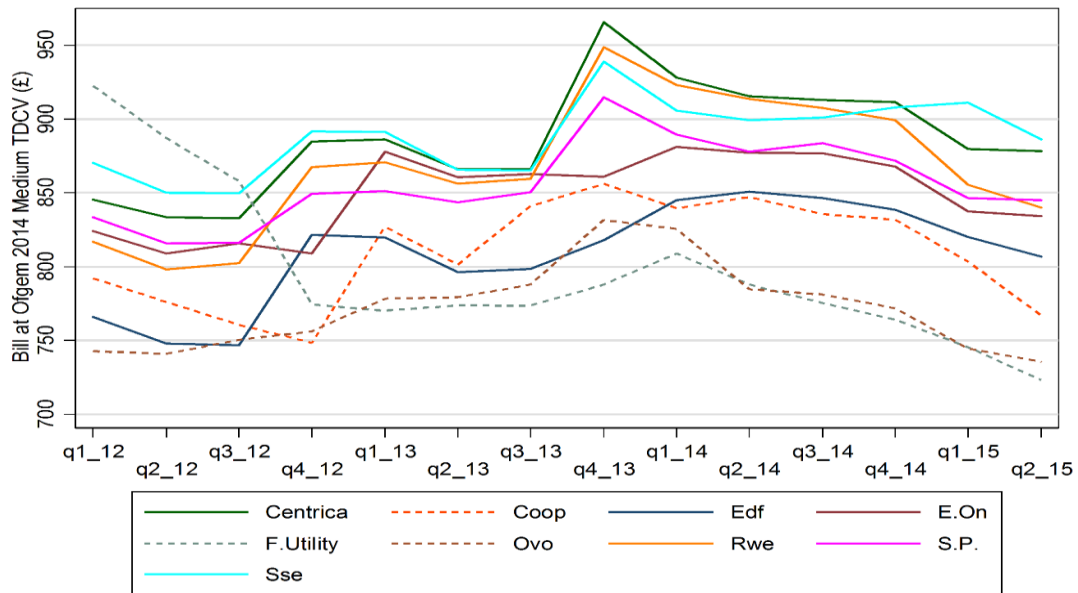
customers might drive their fixed period prices down. On the other hand, entrants with different harvesting expectations offered in many cases even lower fixed terms prices.

Although the argument was made that the excess of the SVT price might be due to customers placing a higher valuation on that contract, and/or that SLEFs provided products with different levels of quality, the CMA failed to (a) identify characteristics of an SVT to which customers might plausibly attach substantial value; and (b) on choice of supplier, saw no evidence to suggest that suppliers offering the cheapest tariffs have worse quality of service than those offering more expensive tariffs.

The size of the gap was calculated by looking at the tariffs which SLEF dual fuel customers did pay, as against what they might have paid if they had chosen a cheaper tariff, either available from their own supplier or from any SLEF. The results over 2012-2015 showed a gap of £205 (16% of the bill) per year for direct debit customers, and £245 (23% of the bill) for standard credit customers. Pre-payment customers experienced a gap of £70 (7 % of the bill). This lower gap was attributed to the relative lack of competition in pre-payment tariffs available to engaged customers.

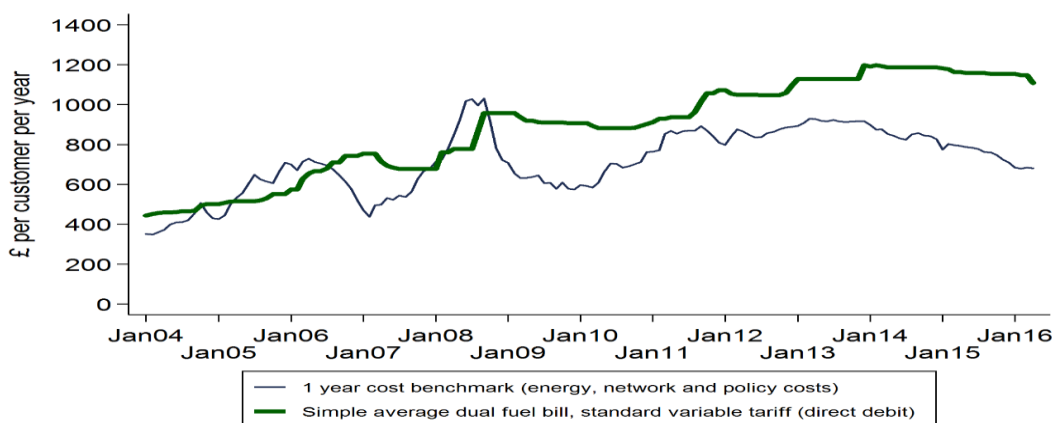
Moreover, as figure 2 shows, the average tariff charged by three of the largest entrants (dashed lines) were substantially less over 2012 to mid 2015 than those charged by the SLEFs solid lines).

Figure 2: Comparison of average dual fuel bills for medium TDCV domestic customers controlling for network and payment method costs (source, CMA Summary, page 27)



And as figure 3 shows, over the period between January 2012 to January 2016, the gap between the average SVT price and an industry level benchmark of direct costs grew in similar fashion. The costs included are energy costs, network costs (which were regulated, and fairly static) and policy costs (which were rising). The reduction in costs thus mainly reflected the fall in world energy prices.

Figure 3: Average SVT price (based on the annual bill for a dual fuel direct debit typical consumption) and a forward-looking industry-level benchmark of direct costs (Source, CMA Summary, page 28.)



Bill is an average across regions and six large energy firms, for a typical consumer. Direct costs are not those actually incurred by firms, but forward-looking expectations. Indirect costs are not shown.

In terms of identifying the causes of these outcomes, several non-exclusive possibilities were identified in the case of the generality of customers. First, weak engagement on the part of some customers with their own SLEF; co-ordination among SLEFs; the impact of dysfunctional regulatory measures.

The third of these factors was recognised in a decision by the CMA that the regulator-determined reduction in the number of tariffs, and other parallel actions, restricted competition. The second – co-ordination – was examined and not found to be present with respect to the timing of increases in the SVT, but not investigated in detail.

The spotlight thus fell on the first factor, which was found to be present. More precisely, the CMA ‘identified a combination of features of the markets for the domestic retail supply of gas and electricity in Great Britain that give rise to an adverse effect on competition (AEC) through an overarching feature of weak customer response, which, in turn, gives suppliers a position of unilateral market power concerning their inactive customer base.’

This was known as the domestic weak customer response adverse effect on competition. The SLEFs disputed the conclusion. But the discussion during the later stages of the report and afterwards revolved around first, how serious was the effect of disengagement, and – particularly - what should be done about it.

3. How was customer detriment in the market estimated?

A key issue affecting the reception of the CMA report was how the customer detriment associated with the retail adverse effects on competition was calculated. It is likely that much of the public debate that followed was influenced by the size of the harm to consumers associated with high SVT prices, which the CMA estimated as averaging £1.4 billion pounds a year over the period 2012-2015. This amounts to an average of more than £50 in each year for every Great Britain household – an uplift in excess of 5%. This annual total is an amount greatly in excess of detriments calculated in earlier CMA market investigations.⁶

There are broadly two ways of calculating the customer detriment. One is to identify the profits made in the activity where adverse effects on

⁶ For example, the detriment calculated in an inquiry into the cement industry, which identified co-ordinated behaviour, was found to be £40 million per year.

competition are found to be operating. This requires a comparison between the cost of capital to the firms involved and the rate of return earned. Neither number is uncontroversial: the former because estimating the cost of capital normally requires implementation of a model based on specific assumptions, such as the capital asset pricing model; the second because both the level of profits and the value of the asset base can also be measured in different ways. The role of the calculation in the first place is to establish a range which assists judgements as to what remedies are proportional in the case in question. Accordingly a range will serve. If these magnitudes are required to implement a remedy, such as a price cap, then the problem takes on a different significance.

The other approach is to seek out an estimate of the competitive price, and to compare the impugned prices with that estimate. This raises the question of how to choose, and perhaps adjust, an observed transaction price.

The CMA employed both approaches, calling the first the indirect method, and the second the direct method.

With most products, the detriment would require knowledge of the slope of the demand curve, and the detriment would be the cumulative loss of consumer surplus over sales excluded by the high price. In this case, the demand curve is implicitly assumed to be vertical with consumption unaffected by price. Given the nature of the retail domestic energy product, this seems to be a reasonable assumption in the short to medium term.

A point arises from the fact that disengaged customers which stick on an SVT rather than search and switch to cheaper fixed term tariffs are also spared the material and other costs of switching. In an ideal world this might be factored in, but in practice our understanding of the distribution of switching costs is quite limited.

In terms of the indirect profit-based method, the CMA's measurement strategy was to estimate a cost of capital to a notional stand-alone retail business, identify a capital base of tangible and intangible assets, and calculate the return on capital employed. The excess profits in any year are then given by the excess of the ROCE over the cost of capital, multiplied by the capital base.

Two more technical points in the calculation are worth noting. The CMA was obliged to rely on comparator data rather than sector-specific data

(which were lacking) to estimate the level of risk in retail energy supply. (See appendix 9.12, para 74.) Second, the CMA capitalised customer acquisition costs and depreciated them using an estimate of average customer life.⁷

A fact which emerged from the investigation is that the retailing costs of the SLEFs differed markedly. The precise data are withheld in the published CMA report, but Ofgem has published data for 2016 for the SLEFs' pre-tax domestic supply margins, gas and electricity. The values in percentages are, in descending order: 7.2, 7.0, 6.9, 5.2, -0.9, -6.3; the aggregate figure is 4.5%.⁸

Two rival approaches to this issue have been suggested. One is to regard these variations as marks of productive efficiency and to normalise the costs at an estimate of an efficient level. The other is to treat them as a rising supply curve and regard the least efficient producer as indicating marginal cost at the output level observed.⁹ The CMA chose the first method. The effect is that its estimate of excess is a combination of realised excess profits and of inefficiently incurred costs.

Over the period 2012-2014, the CMA's detriment figure found by the profit-based indirect method is £1.1 billion (adding together profits in excess of the cost of capital of £650 million and measured inefficiencies of £420 million). If the lowest cost firm were used as the benchmark for productive efficiency, the measure of detriment would increase further to £1.5 billion.

In the case of the direct method based upon a price comparison, the key problem is choice of a competitive benchmark price. The CMA chose to address this problem in the following way:

“[It] is based on the average prices offered by the most competitive suppliers. In establishing the competitive benchmark price, and then making this comparison, we made certain adjustments to observed prices to ensure the comparison is on a broad like-for-

⁷ CMA Final Report, Appendix 9.10, paragraph 64-77.

⁸ See <https://www.ofgem.gov.uk/data-portal/retail-market-indicators>

⁹ The second method seems appropriate when there is an objective reason for the 'rising supply curve.' For example, in a wholesale energy market, more costly types of generating capacity are commissioned as demand, in a well established 'merit order' output rises. But if the variation in generators' costs were due to varying efficiency of operation of the same plant, a regulator would be less willing to fix the strike price on the basis of the costs of the least efficient generator in production.

like basis. These included adjustments for exogenous cost differences relating to network costs and the costs associated with different payment methods, adjustments to reflect the fact that the suppliers in our benchmark are growing rapidly, and hence incurring higher acquisition and indirect costs but lower obligation costs than they would in steady state, and adjustments to achieve a benchmark level of profitability.”

This generated an estimate of £1.4 billion over the years 2012-2015, and showing an upward trend. This is broadly congruent with those emerging from the indirect method for 2012-2014.

4. The household remedies debate.

Remedies occupied a central place in the retail component of the CMA report and the discussion following its publication. This section attempts to give a broader and more thematic account of the arguments that were deployed in this discussion.

The CMA describes its proposed retail remedies as falling into three categories:

- creating a framework for effective competition;
- helping customers to engage to exploit the benefits of competition; and
- protecting customers who are less able to engage to exploit the benefits of competition.

The first category is fairly non-controversial. It involved removing regulation which has an adverse effect on competition, and improving the settlement regime among customers of electricity and gas to improve cost allocation. This process, and the second category of measures too, would be enhanced by the plan for a nationwide roll-out of smart meters, due to be completed by 2020.

The other two categories mirror the distinction between ‘demand-side measures’ which are intended to improve customer engagement, and ‘supply-side measures’ which are designed to change firms’ offers in the market place.

In summary, the demand side measures intended for most or all customers included

- the establishment by Ofgem of a programme to provide customers – directly or through their own suppliers – with information to prompt them to engage;
- creating an Ofgem-controlled database of ‘disengaged customers’ on default tariffs, to allow rival suppliers to prompt these customers to engage in the retail energy markets (the Database remedy);
- enhancing the ability and incentives of third-party intermediaries (TPIs) to promote customer engagement in the retail energy markets;
- Ofgem making greater use of principles rather than prescriptive rules in addressing potential adverse supplier behaviour concerning the comparability of their tariffs.

The supply-side measure was to impose a transitional price cap (up to 2020) on pre-payment customers. These comprised about 15% of all households, and were singled out for this further protection because competition for them was weaker and the detriment greater than for other customers. The price cap would fall away for those in whose homes a fully interoperable meter had been installed.

As section 6 shows, whether this price cap should be confined to pre-payment customers, or whether all customers on a default tariff should be bound by it, became a topic of controversy in the aftermath of the CMA investigation. But it is useful here to discuss in some more detail the pros and cons of demand- and supply-side measures, before describing the final decision reached by the CMA.

Notes on demand-side measures.

By the time the CMA started there was a cacophony of voices lamenting the high level of SVTs and encouraging customers to switch and save. Ofgem had also taken regulatory measures over bill design and such matters to encourage this behaviour. Despite this, the proportion of customers on SVTs (about 65%) fell at a stubbornly low rate, at 1 or 2 % per year, even as switching rates rose. The same slow decline continued throughout the inquiry. This outcome triggered the CMA’s call for a more ‘scientific’ approach to the devising and testing of demand side measures.

It is now clearer that other sectors have experienced mixed outcomes with demand-side measures. Since the publication of the CMA report, our

understanding of demand side remedies in general has been substantially advanced by a thorough account of their application by UK regulators and competition authorities by Professor Amelia Fletcher of the University of East Anglia.¹⁰ I first summarise it, and then separately outline the conclusions that I (not the author) draw from it.

Demand side remedies are defined as regulatory interventions which are intended to enhance competition by helping the demand side of the market to work more effectively.

The remedies fall into three core categories:

- disclosure remedies, requiring suppliers to furnish information
- shopping around remedies, such as the encouragement of price comparison websites
- switching remedies, which make switching quicker and easier.

The author notes that consumers have to be empowered by better information, and also engaged by measures which make the experience of switching easy, attractive to undertake, consistent with ordinary social interactions and timely. But suppliers of disengaged customers may seek to undermine the remedies, and the impact of demand side measures may be to make some customers worse off.

As to the effectiveness of demand side measures, Professor Fletcher reports mixed results, noting that the most observations relate to less sophisticated measures adopted in earlier years. In relation to disclosure remedies, ‘a number of positive outcomes are observed. However, there are also a number of instances in which disclosure remedies were less effective than expected, or even ineffective. Examples are also provided in which disclosure remedies seem to have had a detrimental effect on consumer decision-making’ (p. 34.) The same conclusion applies to shopping around remedies (see p. 51). Switching remedies too exhibit some successes, but there ‘is also evidence of switching remedies that have been less effective, or even ineffective’, reflecting the fact that it can sometimes be hard to enhance switching behaviour. (pp. 65, 66).

The summary of the paper concludes (p.10) that:

¹⁰ The Role of Demand-Side Effects in Driving Effective Competitive: a Review for Which? November 2016.

“Getting such remedies right is difficult. We can sometimes predict how consumers will act on the basis of past experience, but often we cannot.”

The conclusion I draw from the foregoing is as follows. The use of demand side measures has a substantial advantage: if successful, they take the market to the point where most regulators (and commentators) want it to end up – in a state of effective competition, where the combination of productive, allocative and dynamic efficiency may be within reach. They therefore are a desirable component of any package.

But regulators do not generally commit to a forecast of what increase in engagement they expect to see in a market, either in total or as a consequence of the demand-side measures which they introduce. Nor do they generally indicate, in the case of such measures, what level of enhanced engagement would qualify as a success. This lack of precision is a disadvantage in the face of a large consumer detriment.

This uncertainty may abate over time. The programme of testing which the CMA recommended to Ofgem has already borne some fruit, in the form of a large scale random controlled trial involving 137,000 energy customers.¹¹ Half of them received a single standalone letter, designed to encourage SVT customers to switch to a cheaper tariff offered by rival suppliers. The tariffs were based on the recipient’s current energy consumption. One group received a letter branded from Ofgem; one a letter from one of the two suppliers in the trial; the third group received no letter. Of those who received no letter, 1.0 % switched in the following months; 2.4 % of recipients of the Ofgem-branded letter switched, and 3.4 % of those receiving the supplier-branded letter switched.

A much smaller trial involving 2,400 long-term SVT customers examined a letter-based intervention in which some of them received up to six marketing letters from other suppliers, or a best offer letter from Ofgem, or nothing at all.¹² In the last case 6.8% of the group switched; 13.4% of recipients of marketing letters from other suppliers; and 12.1% of those who received the letter from Ofgem. The designers of the trial acknowledged that switching behaviour of the control group is unusually

¹¹ See https://www.ofgem.gov.uk/system/files/docs/2017/11/cm01_report_0.pdf

¹² See https://www.ofgem.gov.uk/system/files/docs/2017/11/small_scale_database_trial_paper.pdf

high. The period in which the trial was conducted also contained some unusual tariff-related events. But those conducting the trial are confident that the rates of switching in excess of the control group are measured in an unbiased way.

This work is still in its infancy. In due course we may derive reliable information from it, and find approaches which can make a real difference to disengagement levels.

A related matter ‘demand side’ issue which came up concerned price comparison web sites, which the customer survey showed were widely used by engaged households. Ofgem had introduced a regulation which required each site complying with Ofgem’s rules to exhibit all the prices on the market. This ensured that ‘single homers’ would see everything – even if many searchers scrutinised several sites. The CMA concluded, however, that this rule chilled competition among sites by making it impossible for one outlet to make special arrangements with suppliers over bespoke tariffs, as happens widely in retail markets. A wider CMA inquiry into ‘digital comparisons tools’, including energy price comparison sites, supported this view.¹³ Ofgem has moved partially to implement this recommendation, and is consulting further.

Notes on supply-side measures.

This discussion is restricted to price control measures; it is thus redundant in a jurisdiction where this is not within the set of relevant choices. Price controls have been used, not always very adroitly, as a means of limiting the exercise of market power since time immemorial. In recent decades, there has been a greater emphasis, especially on the part of competition authorities, on seeking structural remedies for market power as opposed to continuing interventions affecting firms’ behaviour.¹⁴ However, where natural monopoly or other cost properties of networks make structural intervention undesirable, price control may be the chief viable option.

In relation to network activities a standard procedure of setting price controls has developed. The control is notionally based on efficient costs, and to avoid the inefficiency of cost-plus pricing and heighten incentives for efficiency, a forward looking cap is often imposed. It is recognised

¹³ <https://assets.publishing.service.gov.uk/media/59c93546e5274a77468120d6/digital-comparison-tools-market-study-final-report.pdf>

¹⁴ See for example CMA Guidelines for market investigations: Their role, procedures, assessment and remedies. CC3 (revised) April 2013.

that, because cost observations almost inevitably play a role in resetting the cap, the incentive scheme cannot be very high-powered; but benchmarking can be deployed to mitigate this problem.

However, it is unlikely that cost conditions make retail activities a persistent monopoly. Instead, retail market failure is likely to be situated in a potentially competitive space, somewhere between an effectively competitive market where there is no dominant firm, and monopolistic territory. This suggests that the market failure is possibly a transitional state, capable of being converted to effective competition by increasing customer engagement, or even by the passage of time. In other words, the context in which a retail price cap emerges is non-traditional. It raises different issues and requires a different approach. Various dimensions of this challenge are considered below.

This implies that advocates of price controls on retail activities almost invariably support a combination of demand and supply-side measures, and hope/expect that as the demand-side measures take effect, the price controls can be removed.

i) Setting a retail price control.

There is a short cut way which can be used in some circumstances. You can simply look at a basket of the lowest prices in the market, take an average, and use this ‘competitive price’ as the basis for fixing a regulated price.

Ofgem has recently discussed this approach as a way of setting a wide price cap for default tariffs in anticipation of forthcoming legislation. (See section 4 below for further details.) In a recent working paper, it discussed this ‘market basket’ method, expressing the view that in this particular case there are a number of reasons that the most competitive tariffs in the market may not reflect the long-run costs of an efficient supplier.¹⁵

- the cheapest prices in the market will be affected by the state of competition: prices at any time might be above or below the long run costs of an efficient supplier;
- different suppliers might have different underlying cost bases, which could be reflected in the prices they charge;
- as prices would be updated over time, suppliers might set their prices at any time to game the price regulation process.

¹⁵ Ofgem, Working paper No. 1: setting the default tariff cap. 8 March 2018

Ofgem concludes that:¹⁶

‘At this stage, we do not think that a market basket would be a suitable way of setting the initial benchmark [for the regulated price]’ (emphasis in original).

This reasoning may not necessarily apply in other jurisdictions.

The alternative approach is akin to the direct method of establishing customer detriment described above. A competitive benchmark reference price is established by identifying a number of competitive tariffs, adjusting them for factors which are outside the supplying firms’ control, and then adjusting them again to set the retail margin to a normal level.¹⁷ In choosing a methodology for setting the pre-payment price cap, the CMA chose a level of retailing costs based on observations of actual costs and derived a retail EBIT margin of 1.25 per cent.¹⁸ This EBIT margin was calculated on the basis of a firm using a relatively asset-light basis, ie using an intermediary trading arrangement for the procurement of its wholesale energy rather than holding capital, and earning a return on capital equal to its WACC (weighted average cost of capital) of 10%. The CMA also notes that the EBIT margin adopted by UK regulators in the 1990s was 0.5-1.5%, and that the margin in place at the time of the inquiry in Northern Ireland, where retail price regulation of the dominant supplier was in place in a competitive environment, was 2.2%.¹⁹

ii) Enforcing a price control

Price controls can sometimes be circumvented, either directly by overpricing or indirectly by quality degradation. Consumers have an incentive to report the former (if they become aware of it), and it may also be noted and punished by the regulator. Quality issues are less transparent. The evidence from the UK is that even in the absence of price controls the performance of many firms in energy, especially in accurate and timely billing, is variable and often quite poor.²⁰ But imposing a price control may exacerbate it. Regulators may need to consider this issue if they impose a control.

¹⁶ Ofgem, Working paper No. 2: market basket. 28 March 2018, pages 1-2

¹⁷ Ofgem, Working paper No.5: updated competitive reference price, 19 April 2018.

¹⁸ CMA Final Report, paragraph 10. 29.

¹⁹ CMA Final Report, Appendix 9.13, p. 54.

²⁰ CMA Final Report, pp. 629-631.

The likely obedience of firms to prices set in the control makes it possible fairly reliably to forecast its effect on customer detriment. Thus when the CMA imposed a price control on pre-pay energy household customers in GB, it was able to forecast by how much the detriment would be reduced - by nearly £300 million a year.

The operation since early 2017 of the pre-payment price cap has furnished further information on its effects. The trajectory of SVT and pre-payment prices before and after the introduction of the cap in February 2017 shows that between the end of December 2016 and the end of April 2017: ²¹

- the average pre-payment tariff falls by about £100 per year
- the cheapest pre-payment tariff is constant
- the average SVT direct debit tariff rises by about £40
- the cheapest direct debit tariff rises by about £40.

These observations are consistent with the cap bringing pre-payment tariffs down by £100 at a time when the cheapest fixed term (which is likely to be an approximation of the competitive price) and the SVT were rising, possibly in the face of rising energy and policy costs. The imposition of the cap has not led to an increase in the cheapest pre-payment tariff – though individual suppliers may have increased their prices.

iii) Choosing the duration of the price control and the degree of headroom, in the light of customer switching behaviour

In the case of a persistent wholesale monopoly, there is no obvious reason to depart from a straightforward efficient cost-based price control which remunerates fairly all the relevant factors of production. This may involve a risk analysis of errors in cost estimation, which may lead to leaning towards higher rather than lower estimates in very dynamic sectors, but since there is by assumption no prospect of entry, there is no obvious reason expressly to build ‘excess profits’ into the analysis.

But retailing is not a persistently monopolistic activity, and there is general agreement that where competition is feasible, it provides better results than price control. And since Oftel’s recognition in the late 1990s

²¹ See <https://www.ofgem.gov.uk/data-portal/retail-market-indicators> (accessed April 2018)

that some telecommunications markets fell into the category of being potentially, but not yet actually, competitive, it has been recognised that a transitional control can take a different path.

The reasoning for setting the control *above* the estimate of cost, incorporating a degree of headroom can be expressed in two different non-equivalent ways: either that the elevated control acts as a safeguard against the possibility that effective competition develops more slowly than expected; or the control contains headroom in the form of an excess over the competitive price in order to provide a continuing incentive for customers to search and switch. Clearly if the regulated price is perceived as being equal to the competitive price, the incentive for households to ‘learn’ engaged behaviour is removed.

In recognition of this reasoning, when setting its retail price control for pre-payment energy households in Great Britain, the CMA included headroom equal to £15 per household per fuel (gas and/or electricity). Headroom was also a feature of the transitional energy tariffs set in Australian energy markets (see footnote 27 below), in those set prior to the deregulation of retail energy tariffs in the UK, and in certain Oftel-set wholesale market price controls in telecommunications.²²

The optimal scale of the detriment implicit in the headroom thus depends on the trade off between the scale of switching behaviour (promoted by a substantial headroom) and protection of non-switchers, accomplished by a low headroom level. Unfortunately, the evidence on this question is very limited.

In summary, a price control can be designed which takes account of the transitional nature of its role, as the accompaniment of a conscious process to move the market to effective competition. This may influence the level of the control price. More particularly, in order to maintain the incentive to switch as a move towards a market with sufficient customer engagement, headroom may be justifiable.

- iv) Does the evidence suggest that customer engagement can grow under a price control, so that the control can be removed

²² Oftel, Price control review: Future developments in the competitiveness of UK telecommunications markets. A Consultative Document issued by the Director General of Telecommunications, 1999.

The evidence that this approach to price-capping allows the conditions for effective competition to emerge is that in several sectors and jurisdictions, competition in a market subject to a safeguard control has developed to an extent which has led to the removal of the control. Thus retail prices in telecommunications have been fully deregulated in the UK since 2005, following a decision that the markets had become effectively competitive under the safeguard cap.²³ Telecoms tariffs released from price controls are now the norm in the rest of the EU – though intra-EU international roaming is still subject to controls.²⁴

In the energy sector, controls on retail prices were removed in the UK in about 2000, when the relevant safeguard caps were withdrawn. More recently, safeguard caps were withdrawn between 2007 and 2016 in the major Australian States.²⁵ This has not prevented subsequent and sometimes critical examinations of retail energy markets by the ACCC²⁶ and the Victorian government.²⁷ This is not the same as saying that a price cap would have no impact on search and switching behaviour.

v) What effect will the price control have on other prices – is there a waterbed effect?

As we have seen, the CMA found the GB energy market to be characterised by two separate markets: one delivers competitive prices to engaged customers, while in the other, which contains a large number of disengaged households, customers of the SLEFs are charged the much higher standard variable tariff or SVT. There is no competitive process in place which ensures that excess profits made from SVT customers have to be ‘given back’ in price reductions on fixed term contracts.

²³ In 2017, Ofcom held a consultation on a proposal to re-impose price controls for ‘voice only’ (i.e. non-broadband) customers. This was not found to be necessary following an agreement over prices with BT.

²⁴ See ‘market overview table’, available at <https://ec.europa.eu/digital-single-market/en/news/definition-and-analysis-relevant-markets>

²⁵ See AEMC, 2017 Retail Energy Competition Review, and earlier reviews. This complex process is described in Fiona Simon, *Meta-Regulation in Practice: beyond normative views of morality and rationality*, 2017. The country’s energy retail market is subject to a major review by the competition regulator, the ACCC, due to be concluded in June 2018.

See <https://www.accc.gov.au/system/files/Retail%20Electricity%20Inquiry%20-%20Preliminary%20report%20-%202013%20November%202017.pdf>

²⁶ ACCC, *Retail Electricity Pricing Inquiry: Preliminary Report*, September 2017.

²⁷ See *Independent Review of the Electricity and Gas Retail Markets in Victoria*

There is a secondary but separate linkage between the two market prices which has already been noted. If a fixed term customer fails to renew her tariff, then according to the regulatory rules she is transferred on the substantially higher SVT. A firm's customer data enable it to forecast the frequency and duration of such transfers. In setting its prices for fixed term contracts it will take this expected subsequent excess return into account.

Notes on collective switching

A third approach to remedies merits discussion. It involves a direct intervention in the search and switch process, which therefore affects both the demand and the supply side. Essentially it turns it from an individual into a collective process.

In the simplest form, an agent (either a profit or a not-for-profit organisation) advertises for names of customers who may want to switch. Having assembled the names, and collected consumption data, the agent approaches potential suppliers and elicits bids for the supply price schedule they are prepared to offer. Having selected the best supply schedule, the agent then communicates the results to participating customers.

There is then an important fork in the road. In an opt-in variant, customers must then expressly choose to make the switch. If they expressly decline or do not respond, they stick with their existing supplier. In the opt-out version, if they either expressly accept or do not communicate further, they are switched. They only stick if they expressly decline.

The opt-out version is a fairly standard example of collective purchasing designed to aggregate and strengthen buyer power. It has been widely used, for example, by the Australian organisation *One Big Switch* in many markets, including banking, insurance, petrol and energy. The opt-out version is much more interventionist, and will almost inevitably require some form of approval by a qualified authority, or even primary legislation.

The choice between them is important because the history of opt-in switches suggests that many customers to whom substantial savings from a switch are available do not switch. This may be the result of second thoughts, or of inattention, or because the saving is too small, or from

increased anxiety about the process as it becomes more imminent, or a combination of the above and other reasons.

In the UK, one particular opt-in collective switch (The Big Switch of 2012 – see also the discussion above) has been examined thoroughly, as a result of a careful analysis of the data by economists at the University of East Anglia.²⁸ At the time, suppliers are reported to have felt themselves restricted in responding to the offer to purchase by regulatory restrictions on the tariffs they could offer. Another feature of the process is that about half of customers received two offers, the second one reflecting local cost conditions.

The authors note that

the most important findingis that even among a group of motivated consumers who had committed considerable time up front to enter the auction, and were faced with a minimum of additional effort to complete a switch once they received an offer, switching was surprisingly low. Among all the participants who provided complete data (around 147,000 consumers) the switching rate was 24%.... only around a third of the total savings available to the participants were actually captured by switching through the auction.

As the fixed term deal ended, only a proportion of beneficiaries realised that it had done so, and over half of those who did know accepted an offer from their Big Switch energy supplier.

Ofgem is currently conducting a trial of what it calls an active choice collective Switch Trial, in which an ‘on your side’ third party which additionally to negotiating and informing customers also ‘provides online and phone routes to switch to the new tariff and/or conducts a wider search comparing tariffs across the market.’²⁹

The outcomes described above have encouraged further study of opt-out switches, organised by co-called ‘municipal aggregators’. These have been in use in six or seven states in the USA for some years, usually after approval by local voters. The supplier is often the local incumbent (which

²⁸ Deller, D., M. Giuliatti, J.Y. Jeon, G. Loomes, A. Moniche and C. Waddams, ‘Who Switched at ‘The Big Switch’ and Why?’, report for Which?, Centre for Competition Policy, University of East Anglia, Norwich, England, 2014. See also the discussion at

²⁹ https://www.ofgem.gov.uk/system/files/docs/2018/02/collective_switch_trial.pdf

may lobby against the scheme). Other countries may find it hard to replicate the US political and institutional framework.

In research for Ofgem³⁰, the University of East Anglia has considered options for organising a collective switch directed at the 10 million disengaged households which Ofgem believes exists in GB. Their conclusions are that achieving a high participation rate requires an opt-out mechanism, which faces the following issues:

- implementation may create issues over the compulsion of customers and the privacy of their data
- it would be difficult to accomplish so large a task in a short time
- the effect of reducing prices for disengaged customers may be to raise them for active customers
- an opt-out switch does not by itself lead to any long term increase in customer engagement.

The CMA's decisions in relation to retail remedies.

Collective switching featured little if at all in the CMA's final report; possibly because at the time it was little understood and tested. As a result, the principal issue was how to combine demand-side measures and price caps.

This was resolved in favour of a suite of demand-side measures accompanied by a temporary price cap on pre-payment tariffs. The pre-payment price cap was not justified by lack of customer engagement, but by the presence there of "certain technical constraints limiting the number of tariffs that suppliers can offer to customers on dumb prepayment meters and softened incentives for all suppliers, and in particular new entrants, to compete to acquire all prepayment customers"³¹. In other words the CMA decided to address disengagement via demand-side measures rather than by a price control. The reasoning behind this decision was that pre-payment customers were particularly badly affected by the lack of competition for their custom, but that a wider price cap would have adverse consequences:³²

³⁰ David Deller et al, Collective Switching and Possible Uses of a Disengaged Consumer Database, august 2017, available at <http://competitionpolicy.ac.uk/documents/8158338/19064125/Collective+Switching+Report+-+August+2017.pdf/127c78b6-faad-4496-b198-f56862230896>

³¹ CMA Summary, para 167. One of the five Group members (the present author) favoured a wider price cap on all default tariff.

³² Summary, pp. 59-60.

“251. Our decision on whether to introduce a cap for all standard variable tariff customers was balanced. The majority of us concluded that the disadvantages of attempting to address the detriment of all customers on the standard variable tariff through a price cap would likely be disproportionate. The majority of us believe that attempting to control outcomes for the substantial majority of customers would – even during a transitional period – run excessive risks of undermining the competitive process, likely resulting in worse outcomes for customers in the long run. This risk might occur through a combination of reducing the incentives of suppliers to compete, reducing the incentives of customers to engage and an increase in regulatory risk.

252. Since, as noted above, a large part of the detriment we have observed in the form of high prices is likely due to inefficiency rather than excess profits, we believe the best, most sustainable approach to reducing this detriment in the long term is through fully competitive markets, in which more efficient suppliers gradually replace less efficient suppliers. We also note that for most domestic customers on standard variable tariffs detriment will be reduced as soon as they engage effectively, in contrast to the situation for prepayment customers, who do not have access to cheap tariffs. Having considered very closely both the short-term benefits to customers and the longer-term risks that a broader cap may create, set against the features of the Domestic Weak Customer Response AEC, the majority of us have therefore decided not to control prices across all customers on standard variable tariffs. Martin Cave dissented from this view, considering that a broader cap was required to address the scale of detriment identified in the short term.”

One of the five Group members (the present author) favoured a price cap on all default tariffs, arguing that the demand side measures did not provide a reliable and timely means of dealing with the detriment and that the adverse effect of a price cap on engagement was limited.³³ Thus the disagreement between the majority and the minority revolved around the effects of both demand-side measures and a price cap.

³³ CMA Report, pages 14

5. *Small firm and microbusiness tariffs*

The terms of reference of the energy market investigation expressly included ‘microbusinesses’ which are a subset of small and medium sized enterprises (SMEs) satisfying one of the following criteria:

- (a) they employ fewer than ten employees (or their full-time equivalent) and has an annual turnover or balance sheet no greater than €2 million; or
- (b) they consume no more than 100,000 kWh of electricity per year; or
- (c) they consume no more than 293,000 kWh of gas per year.

Some microbusinesses use as much as thirty times the average domestic consumption, but a quarter use no more than an average household. Unlike the domestic markets, microbusiness contracts are largely single fuel, even among customers using both fuels.

The CMA describes the contractual arrangements for microbusinesses as follows (para. 16.15-18):

“Microbusinesses are primarily on fixed-term, fixed-price contracts. In the domestic markets, the majority of customers are on SVTs. In contrast, in 2013, variable-price products only covered 19% of electricity customers treated by suppliers as microbusinesses and 26% of gas customers treated by suppliers as microbusinesses.

Tariffs for non-domestic customers are or can be set on an individual basis, unlike the domestic markets where there are a limited number of tariffs available (due to licence conditions limiting tariffs). New contracts and renewals can be negotiated on an individual basis, or can be set using a number of price points; evergreen contracts and contracts renewed without negotiation may also still be set individually. In contrast, domestic prices are published (and therefore not subject to negotiation). When an existing fixed-term contract comes to an end, small business customers have the right to negotiate a new contract or switch supplier. It has historically been the case that many small business customers have not done so and have instead been moved to an ‘auto-rollover’ contract: a new fixed-term, fixed-price contract which is likely to include a different price from the original contract, and which customers cannot leave mid-term.

Since 2013, the largest suppliers of energy to small businesses (including the Six Large Energy Firms and Opus Energy) have gradually withdrawn auto-rollover contracts, as a result of pressure from Ofgem and the government. In their place, suppliers have introduced a variety of different replacement tariff types for SME customers who do not take action at the end of their contracts (including evergreen tariffs and fixed term contracts, both of which a customer can give notice to leave at any time, unlike auto-rollovers).

Finally, bad debt is a more substantial issue for suppliers in the SME markets, due to the risk of businesses ceasing trading. This is particularly the case since some customers will be supplied without the supplier having any details of the customer or payment arrangements.'

In more detail, microbusiness tariffs fall into the following principal categories: (percentage shares are indicated in brackets³⁴)

- Fixed term contracts, for customer acquisition and retention (55%);
- Auto-rollovers: when a non-domestic customer's existing fixed-term contract comes to an end, this may automatically be followed by an extension of the existing fixed-term contract or a new fixed-term contract (if the customer takes no action); often at a different price from that of the original contract (26%);
- Evergreen contracts: these contracts have no termination date and the prices are changed periodically (9%);
- Deemed tariffs: these tariffs apply to non-domestic customers that have not signed up to a contract but consume energy. This may, for example, when a non-domestic customer moves into a new property and starts to consume energy without a contract with a supplier (8%);
- OOC (Out of contract): this applies to non-domestic customers that have terminated their contracts, but have not yet switched to a new supplier (2%).

Of these, all but the first are 'default' tariffs. Customers are not on them as a result of an active choice. Their level is significantly higher than the

³⁴ Source: CMA Final Report, paragraph 16.37.

fixed term contracts; in the case of deemed and OOC contracts, about twice as high.³⁵

Microbusinesses sometimes deal directly with suppliers, sometimes with third party intermediaries, which may be rewarded by the supplier.

A 2015 survey for Ofgem also found that a sizeable minority of microbusinesses had not switched supplier recently. Thus 39% of businesses with zero employees (ie owner-operators), 34% of businesses with one to four employees, and 28% of businesses with five to nine employees had not switched supplier over the past five years.

The CMA report does not disclose the SME or microbusiness market shares of the SLEFs, confining itself to saying that the SLEFs are important players in both electricity and gas markets, but some of them only have small SME gas supply activities.

In the case of the SLEFs available data showed a comparison of supply profit margins in the household, SME and Industrial and Commercial Companies (large firm) sectors. This showed substantial differences in EBIT margins, which on average were as follows:

Table 1. Combined EBIT Margins of the SLEFs in various retail markets, 2009-14.

	%
Domestic	3.5
SME	8.0
Industrial & Commercial	1.9

Source:CMA Final Report, Appendix 9.13.

SME margins on gas (9.9%) exceeded those on electricity (7.4%).

These circumstances led the CMA to reach in the case of microbusinesses the same conclusion as they did with domestic customers, namely (para 20.16)

“that a combination of features of the markets for retail supply of gas and electricity to SMEs in Great Britain give rise to an AEC through an overarching feature of weak customer response from microbusinesses³ which, in turn, give suppliers a position of unilateral market power concerning their inactive microbusiness

³⁵ Ibid., paragraph 16.86.

customer base which they are able to exploit through their pricing policies or otherwise (the ‘Microbusiness Weak Customer Response AEC’).”

The CMA estimated that the annual detriment to microbusinesses amounted to £220 million per year, about 15% of the detriment to household customers. Although microbusinesses are often fragile, it was considered inappropriate to identify special categories of ‘vulnerable’ customers.

The chief remedies imposed were:

- to end auto-rollover contracts with certain restrictions (such as termination fees) that restrict microbusiness customers’ ability to switch;
- to increase price transparency and establish a programme to provide microbusiness customers with information to prompt them to engage;
- to provide prompts to microbusiness customers on default contracts by enabling rival suppliers to contact them.

The first of these is a fairly strong supply-side measure; the remaining two are replicas of demand-side measures adopted for the domestic market. A price control for pre-payment microbusiness customers was rejected on *de minimis* grounds.

6. What happened after the CMA review was completed.

Changes in the market place

The demand-side measures implemented following the CMA report were bound to take some time, especially when they had to be trialled. Evidence on their overall effect on tariffs is therefore limited.

As far as switching is concerned, the proportion of household energy customers which had switched in the previous 12 months grew from 14% to 17% between July 2016 and 2017, the highest level since 2011.³⁶ It continued to grow thereafter. In calendar year 2017, the proportion of net gains for medium and small suppliers out of the total number of switches was nearly 30%. As a consequence, the share of the SLEFs fell by 5

³⁶ See Ofgem, State of the Market Report 2017, page 25, available at https://www.ofgem.gov.uk/system/files/docs/2017/10/state_of_the_market_report_2017_web_1.pdf

percentage points to 78% for gas and 79% for electricity.³⁷ (By definition, the households lost by switching from SLEFs to non-SLEFs are low-margin engaged customers.)

The share of non-prepayment households on standard variable tariffs (including a few non-standard variable tariffs) was 64% in April 2016, 60% in April 2017, and 57% in October 2017.³⁸

No attempt has been made to replicate the CMA's detriment calculations, but Ofgem's measure of the gap between the average level of SVT tariffs of the SLEFs and the cheapest tariff on the market registered £343 in July 2016, £293 in July 2017 and £325 in March 2018.³⁹

These data show an increase in supplier switching, overall in favour of smaller suppliers. The proportion of non prepayment customers on SVT's is declining at a faster rate than previously. On the other hand, a majority of households are still on SVTs, and the gap between the average SVT tariff and the cheapest tariff shows no declining trend.

Regulatory and legislative changes

The CMA final report was published on the day that the Brexit referendum result was announced. Most of it was respectfully received. Thus it upheld earlier provisional conclusions about the satisfactory working of the wholesale electricity and gas markets and the lack of problems with vertical integration between generation and retailing. No energy company used its right to appeal against the CMA's decisions to the Competition Appeals Tribunal.

However the limited extent of retail price control came in for some criticism. Critics included the relevant government minister, the Conservative Secretary of State for Business, Energy and Industrial Strategy, who expressed particular concern about the higher prices which loyal energy customers were being charged.

³⁷ Ofgem Retail Market Indicators (accessed May 2018) available at <https://www.ofgem.gov.uk/data-portal/retail-market-indicators>

³⁸ See Ofgem, State of the Market Report 2017, page 26, available at https://www.ofgem.gov.uk/system/files/docs/2017/10/state_of_the_market_report_2017_web_1.pdf

³⁹ Ofgem Retail Market Indicators (accessed May 2018) available at <https://www.ofgem.gov.uk/data-portal/retail-market-indicators>

The Government asked Ofgem if it would use its powers to introduce a wider price cap by the standard method of new licence condition on the SLEFs. This had the disadvantage that the appeal body would be the CMA, which had just declined to introduce such a measure (though the group of four or five decision takers at the CMA in the licence change appeal would be different from those involved in the energy market investigation). Ofgem declined to do so, stating that they needed a political mandate to act.

In the meantime Ofgem successfully introduced the pre-payment price control in early 2017, and in later 2017 was successful in imposing an additional price control on about a million households whose individual circumstances made them eligible for the Warm Homes Discount Scheme, under which each received a reduction of £140 per year in their energy bills. An above-average number of these customers were on the SVT. Ofgem chose to set this price control at the same level as the pre-payment control. As the costs of serving a pre-payment customer are estimated to be £64 per year above those on the direct debit payment method, the price cap for the added households implicitly included a larger headroom.

In June 2017, the government published a Bill which would instruct Ofgem to introduce a price control with the following features. It was subject to pre-legislative scrutiny by the relevant Committee of the House of Commons and unanimously supported.⁴⁰

The Bill was introduced into parliament in February 2018.⁴¹ It can be summarised thus:

- A time-limited cap is to be imposed by Ofgem on standard variable and default energy tariffs, until a date between 2020 and 2023 to be determined by Ofgem following reviews;
- In setting the tariff, Ofgem “must have regard to the following matters—
- (a) the need to protect existing and future domestic customers who pay standard variable and default rates;
- (b) the need to create incentives for holders of supply licences to improve their efficiency;
- (c) the need to set the cap at a level that enables effective competition for domestic supply contracts;

⁴⁰ <https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/517/517.pdf>

⁴¹ <https://www.gov.uk/government/collections/domestic-gas-and-electricity-tariff-cap-bill>

- (d) the need to maintain incentives for domestic customers to switch to different domestic supply contracts;
- (e) the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.”

If enacted before the summer recess the control will be in place by the end of 2018. Ofgem is currently working out some of the details of how the price control would work.

7. Possible lessons for New Zealand

The CMA report was a very long and testing exercise involving a maximum of several dozens of professionals in law, economics, accounting and other disciplines over a two year period. It was undertaken within a legal framework which carried the risk of fairly draconian remedies for firms in the relevant markets. As a result, the possibility of an appeal against the CMA’s conclusions, processes or remedies was in everyone’s mind.

The New Zealand exercise is smaller and quicker, and an input into a wider governmental process rather itself being a trigger for the implementation of remedies. This will permit more agile procedures, shorter consultation periods, and a much less comprehensive output.

However, as with the CMA inquiry, the scope of the NZ inquiry goes wider than retail markets. The CMA inquiry involved retail and wholesale energy markets, and it was inevitable that these would be investigated thoroughly, together with the vertical integration across them. (Network regulation, which raises rather different issues, was expressly excluded.) In the event, the wholesale market and vertical integration issues were not found to be very problematic at the half way stage of provisional findings, so that later efforts were focussed on the household and small business retail market and on certain more detailed issues (such as arrangements for setting energy codes or locational pricing for transmission) . I suspect that the sooner the NZ inquiry can decide where to focus its efforts, the better.

In relation to the retail aspect of the CMA inquiry, it was helpful to have good factual evidence on how the market was working, in terms of which type of household was paying what, how much searching and switching were occurring, and why. There are different ways in which such data can be collected, and early publication of the results – if they identify market failures – is a good way of setting a context for later contributions.

Such data might also be able to shed light on any accentuation of harm for vulnerable customers. This phenomenon is observed in a number of deregulated energy markets, including in the US.⁴² There is scope for endless disagreement on how precisely to enumerate and count vulnerable groups, but less so about whether a particular group contains a high proportion of vulnerable people.

There are reasons to believe that energy is one of a number of markets – which also include some telecommunications and financial services – which are particularly susceptible to consumer disengagement. In energy’s case, the problem is not one of product differentiation. It is more closely associated with the complexity of the tariff structure which is multi-part and makes price comparisons difficult, as customers have to submit detailed information about their expected or current level of demand (which is particularly difficult if customers are not on smart meters). This puts suppliers in a place where they can offer individual deals to households and differentiate them in the different channels of communication available to them. Thus, in the case of a household currently on a high cost evergreen tariff, the goal may be to avoid ‘waking them up.’ A second best might be to make an ‘internal switching’ offer of an alternative tariff from the same firm (which might be quite expensive). At the same time the supplier might advertise this same contract – in terms of duration of contract, general tariff structure, leaving charge) at a quite different price in a channel frequented by searchers such as a price comparison website. These practices can be countered by regulating the information which customers receive, but it may still be difficult to customers to act upon it.

Levels of and margins in energy prices for different groups of consumers and firms vary considerably across international boundaries, and are highly likely to be a point of contention. In the UK inquiry, SMEs were shown to suffer the same form of discriminatory treatment as households. The overall margins in their tariffs were very high, and the CMA adopted some remedies in their favour. But despite the power of trade groups like the Federation of Small Businesses, the amount of media attention they achieved was predictably dwarfed by that granted to domestic consumers.

⁴² Catherine Waddams Price (2018) Back to the Future? Regulating Residential Energy Markets, *International Journal of the Economics of Business*, 25:1, page 152, available at https://ueaeprints.uea.ac.uk/66445/1/Published_manuscript.pdf

As far as remedies are concerned, the choice will likely vary with the severity of the market failure, which is usefully measured, when circumstances permit it, by the customer detriment. This is likely to be correlated with the salience of the problem in the country's personal and political discourse, and to be affected by prevailing attitudes to regulatory interventions in general.

There is a spectrum of responses. At one end, a decision to use demand-side measures alone to counter disengagement. In the middle, the position of the current UK Government, which is to introduce a temporary safeguard cap to 'reset' the market, but in a way which allows for its removal as parallel demand-side measures take hold. At the other end of the spectrum, all hope of effective retail competition is abandoned, and price control kept on indefinitely.⁴³

⁴³ A further option which combines (perhaps somewhat uneasily) both extremes is proposed in the Independent Review into the Electricity and Gas Retail Markets in Victoria, August 2017; its recommendation is to 'require each retailer to provide a 'no frills' offer that does not exceed a regulated price. Consumers only interested in a basic 'no frills' service would have the option to select the Basic Service Offer and remain protected from the existing failures of the market. Retailers would be free to continue to offer additional offers at different prices which, may be lower than the 'no frills' option, or higher, to give consumers the choice to pay for any additional value offered by retailers. However, this Basic Service Offer would be available to all consumers and would represent a reasonable price of energy in the market. It would provide an option for consumers who just want affordable energy without the fuss.' (page 10).

Appendix: The customer survey undertaken by the CMA Market Investigation.

The lengthy prelude to the investigation, which took in the period when the gap between the SVT and the competitive price widened in 2011-2014, provoked much discussion of how customers viewed the market but relatively little reliable information.

The CMA thus decided to conduct a large scale survey of consumers, costing several hundreds of thousands of pounds and involving a 20 minute telephone interview with 7000 stratified respondents. The topics were:

- Searching and switching: the incidence of searching and switching both between suppliers and within suppliers (e.g. switching tariffs) and the outcomes of decisions (e.g. the savings made).
- Drivers of behaviour:
 - awareness of who their supplier(s) is/are, the tariffs to which they subscribe and the right to switch,
 - triggers for searching and switching,
 - information available to and used by domestic customers and approach to the assessment of information,
 - expectations and experience in relation to the gains to be had from switching and the risks and costs associated with doing so, and
 - the decision making process.
- Role and use of price comparison and cashback sites.
- Customer characteristics – how drivers, behaviours and outcomes vary by customer attitudes, and demographics.

The results are available in different forms:

- the conducting agency's overall report⁴⁴
- the agency's technical report, including the questionnaire⁴⁵

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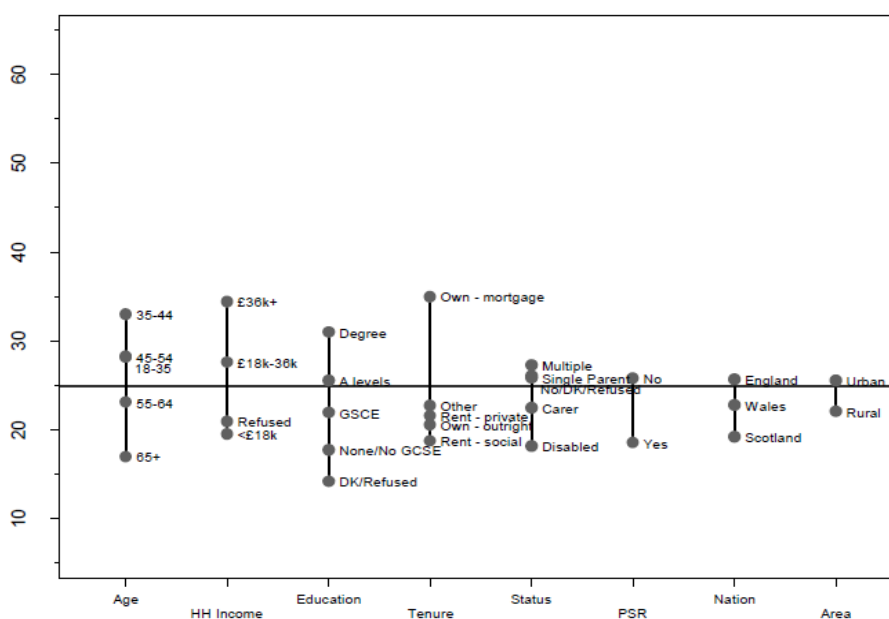
https://assets.publishing.service.gov.uk/media/54e75c53ed915d0cf700000d/CMA_customer_survey_-_energy_investigation_-_GfK_Report.pdf

- the CMA’s own interpretation of the results, which contains a 15-page summary of overall findings.⁴⁶

This appendix is even more abbreviated, but, for illustrative purposes, it shows how cross-tabulation can identify important features of household behaviour. The figure and table numbers correspond to those in Appendix 9A of the CMA final report: see footnote [36].

‘Figure 2: Proportion of supplier switching in the last three years by demographic and household characteristics’ (page 24 of CMA appendix 9A)

This shows, for example, that switching rates decline with greater age, lower incomes, less education, rented rather than owned homes, and rural living.



Source: CMA analysis of survey and supplier data.

Notes:

1. Derived from responses to questions K1, K3, K4, K5, K6 and records provided by supplier. PSR indicates whether respondent is on the PSR. Those who were unable to respond to relevant questions (ie answered 'do not know') have been excluded.
2. 'DK' indicates responded who answered with 'Don't Know' to the relevant surveys question
3. Base = age 6,901, income 6,999, education 6,665, tenure 6,999, status 6,999, PSR 6,990, nation 6,999, area 6,976.

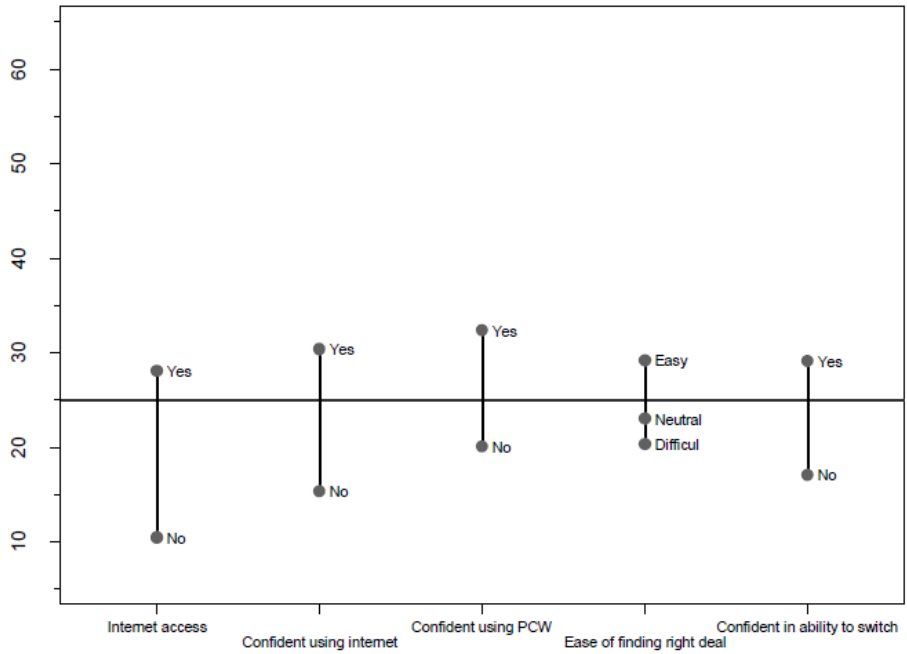
45

https://assets.publishing.service.gov.uk/media/54e75c65ed915d514400002c/CMA_customer_survey_-_energy_investigation_-_GFK_technical_report.pdf

⁴⁶ CMA Final report, Appendix 9A, CMA domestic customer survey results, available at

<https://assets.publishing.service.gov.uk/media/576bcbbc40f0b652dd0000b0/appendix-9-1-cma-domestic-customer-survey-results-fr.pdf>

‘Figure 3: Proportion of supplier switching by capability and confidence measures’ (page 25)



Source: CMA analysis of survey data.

Notes:

1. Derived from responses to questions H1, H2, H3, F3 and F4. Those who were unable to respond to relevant questions (ie answered 'do not know') have been excluded from the two rightmost bars. Those who do not know if they have internet access, are confident internet users, or PCW users have been classified as not having internet access and not being confident respectively.

2. Base = internet access 6,999, confident using internet 5,927, confident using PCW 5,867, ease of finding right deal 6,702, confident in ability to switch 6,828.

‘Table 12: Minimum savings needed to encourage respondents to switch supplier’ (page 39)

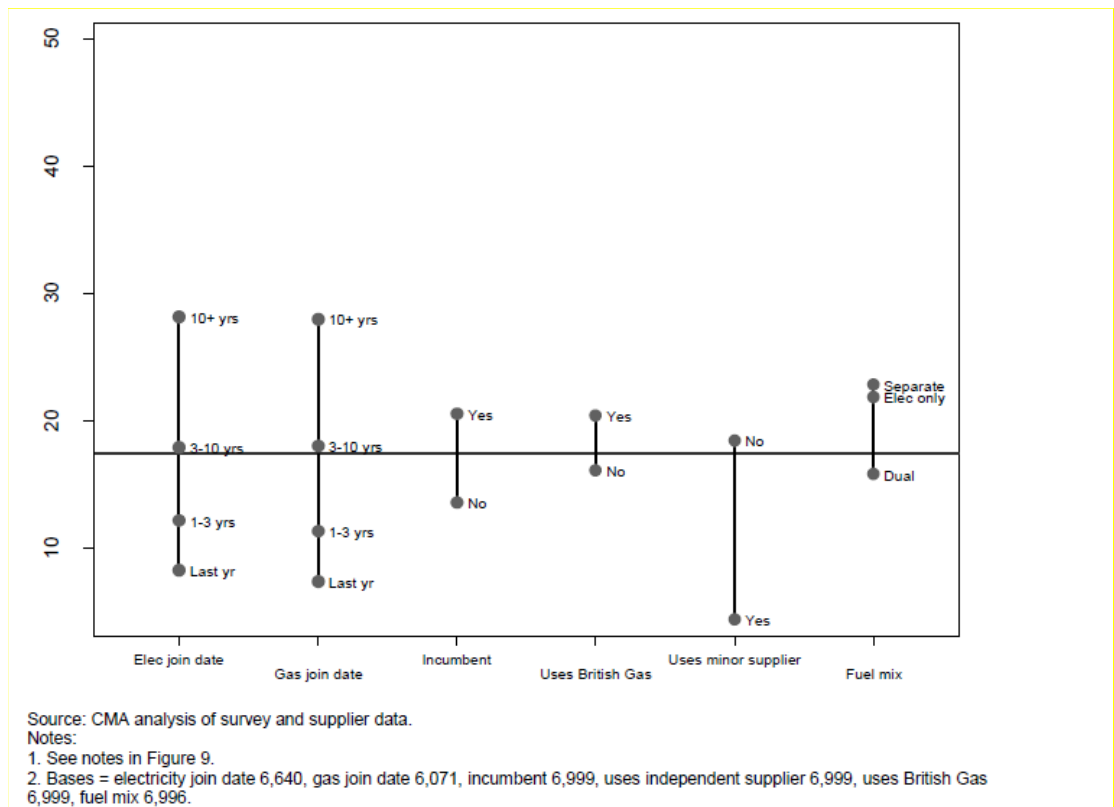
Annual savings	Share (%)	Cumulative (%)
£0	1	1
£1-49	6	7
£50-99	18	25
£100-149	31	57
£150-199	5	62
£200-249	19	81
£250+	19	100

Source: CMA analysis of survey data.

Note: Drawn from question F5 which asks, 'What would be the minimum amount of money you would have to save to encourage you to switch your (... fuel type) supplier? Just approximately'. 25% of respondents were not able to provide a response to this question. Base=5,198 excluding those who responded 'do not know'. For further discussion of variable F5 see Annex B, paragraph 25.

‘Figure 32: Proportion with no internet access by supplier characteristics’ (page 80)

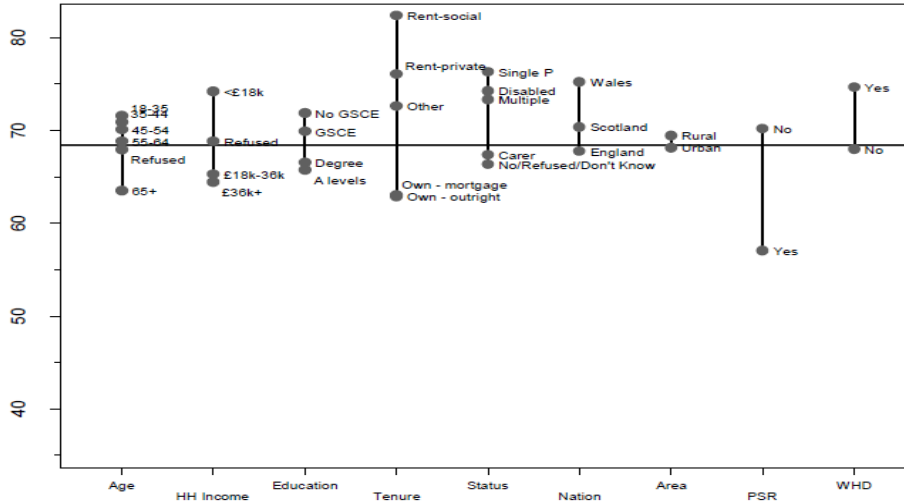
This shows the proportion of respondents with no internet access by certain supplier characteristics. Nearly 30% of respondents who had been with their electricity or gas supplier for more than ten years do not have internet access.



‘Figure 41: Proportion of SVT usage by demographic and similar characteristics’ (page 92)

Unsurprisingly, this is the obverse of ‘figure 2’ above on switching propensities.

Figure 41: Proportion of SVT usage by demographic and similar characteristics



Source: CMA analysis of survey data.
 Notes:
 1. See notes at Figure 2.
 2. WHD refers to whether a respondent is on the Warm Home Discount Scheme.
 3. Bases (from left to right) = 6,901, 6,999, 6,665, 6,999, 6,999, 6,999, 6,976, 6,990, 6,990.