

# Ofgem, the CMA and the retail energy market: economics or politics?

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# Ofgem policy change 2008

- c 1998 energy markets opened to retail competition
- 2002 transitional price caps removed, Ofgem reported that competition flourished
- Jan 2008 “Market is sound - Ofgem assures Chancellor”
- Feb 2008 “Ofgem launches Probe to address mounting concern”
- Oct 2008 Ofgem Initial Findings: competition not working
  - Concern about “unfair price differentials”, only small proportion of customers active, vulnerable customers were less active
- 1<sup>st</sup> Solution: Non-discrimination condition SLC 25A (2009-12)
- Crackdown on doorstep selling – companies abandon it

# Ofgem policies 2010-14

- Customer engagement halved by 2012 (20% to 10% pa)
  - Supplier prices and profits increased
- Suppliers develop greater variety of tariffs
- 2010 Ofgem announces Retail Market Review (RMR)
- 2011 Ofgem blames complex tariffs for fall in switching
- 2<sup>nd</sup> Solution: Ofgem's Procrustean Bed
  - all suppliers to have same fixed charge set by Ofgem & compete on variable charge
- 2012 Ofgem abandons Procrustean Bed policy
- 3<sup>rd</sup> Solution: simpler tariffs policy
  - max 4 tariffs per supplier, no discounts, no 3-part tariffs, require to notify cheapest tariff
- 2014 still concerns – Ofgem refers energy market to CMA

# Can economics explain policies?

- No recognition by Ofgem that price differentials can be evidence of competition, not lack of it
- April 2009 Yarrow resigns as GEMA Non-Exec:
  - “almost professional consensus that non-discrimination condition would harm competition & customers”
- June 2009 Ofgem: “three academics strongly opposed”
  - Waddams (CC), Vickers (ex-DGFT), Yarrow (ex-GEMA NED)
- No economists support subsequent Ofgem policies
- Economists later found evidence of adverse effects
  - increased bills, profits, reduced switching, reduction in competition & innovation (Green, Waddams, Yarrow)

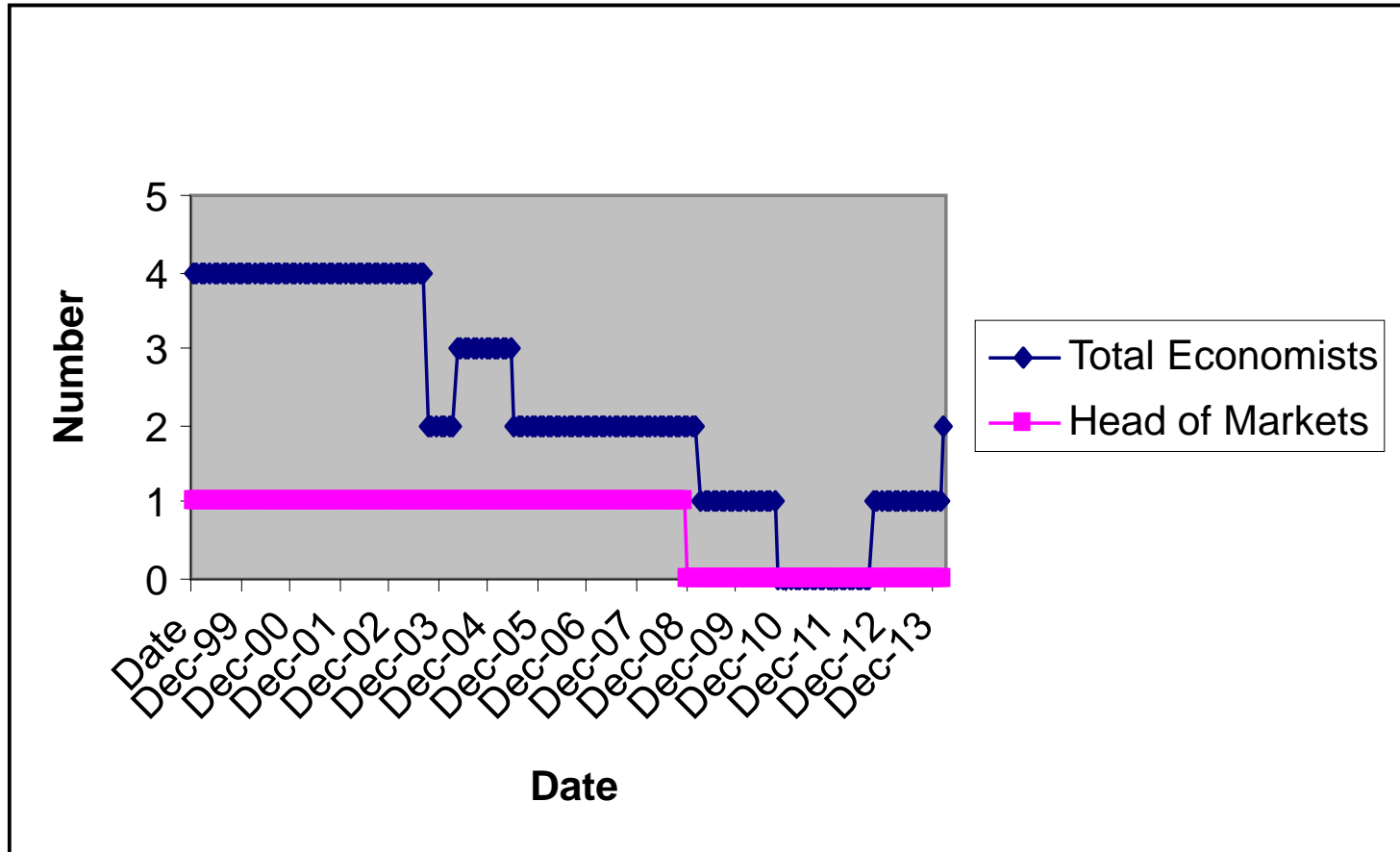
# CMA verdict on Ofgem policies

- CMA confirms adverse effects of regulatory interventions
  - “Since [2008], a variety of regulatory interventions have served to soften competition - including SLC 25A, enforcement action by Ofgem leading to the abandonment of doorstep selling by most competitors and more recently RMR – resulting in a fall in switching rates and an increase in the gap between the Standard Variable Tariff and direct costs ” (Final Report 2016, 11.38-9)
- “simpler choices component of RMR gives rise to an Adverse Effect on Competition through reducing suppliers’ ability to innovate”
- CMA Remedy: remove simpler choices component of RMR
- Conclusion: no economic basis for Ofgem policies, & they have been harmful to competition & customers

# Ofgem abandoned economics

- “I pay tribute to [Alistair Buchanan’s] energetic, expert and transformational role in leading Ofgem from a body that was essentially an economic regulator ten years ago to its current and far more multi-dimensional purpose and activities.” Sir John Mogg 2013
- For over five years from January 2008 the Head of Markets Division was not an economist.
- For a significant two-year period (Nov 2010 - Oct 2012) there were no economists at all on the GEMA board.

# Economists on the GEMA Board



# BACK TO THE FUTURE

2008

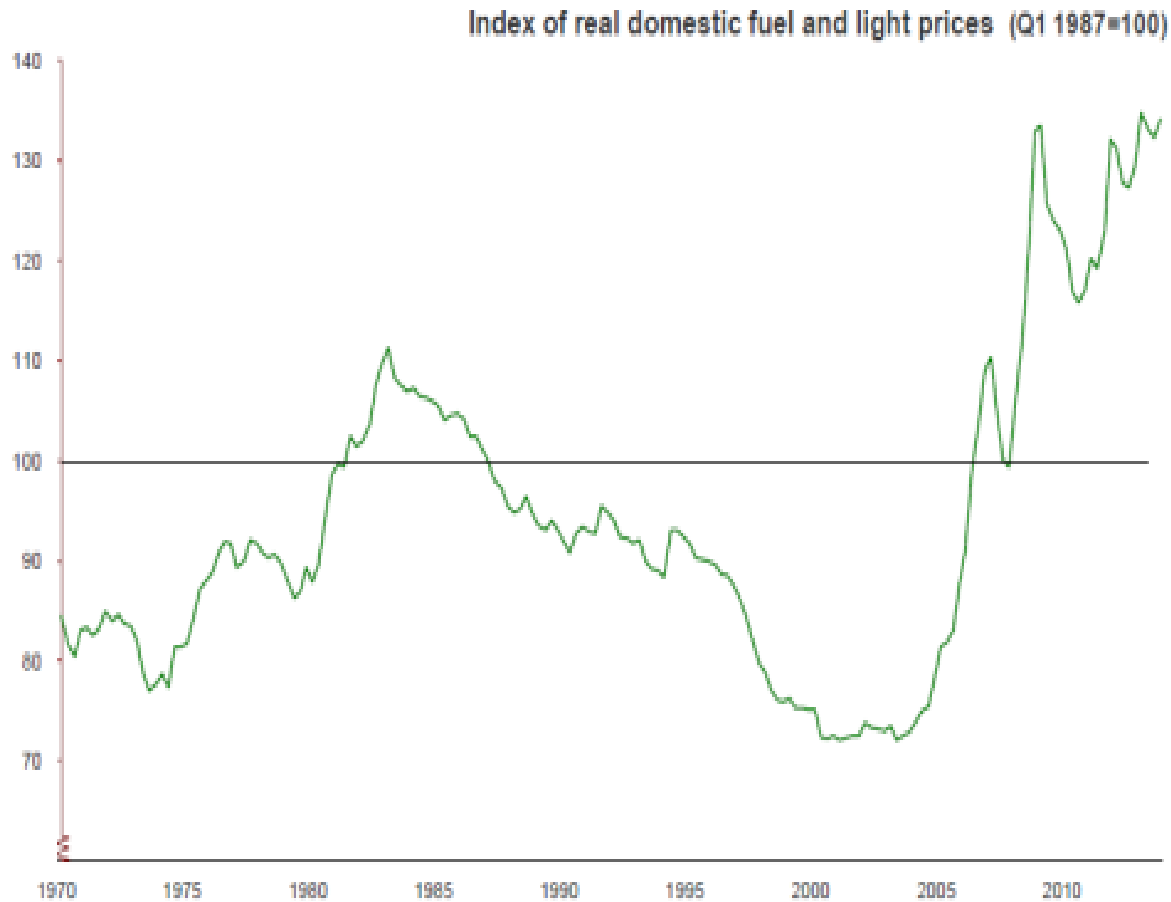
Economics?? Where we're going, we don't need economics...



ofgem



# Context: energy prices doubled 2004-09



Source: Quarterly fuel prices, DECC, Table 2.1.1

# Politics: Labour Government

- 1979-1997 Conserv Govts pro-market pro-competition
- 1997-2008 Labour Govts pro-market pro-competition
- Oct 2008 DECC created, Ed Miliband Sec of State
  - “determined to work with Ofgem to root out unfair practices”  
Dec 2008
  - “a complete rewrite of UK energy policy” ...  
investment decisions “cannot be left to the market” Apr 2009
  - “welcome Ofgem’s Probe measures ... regulator should be  
active ... [including] through other more direct interventions”  
Oct 2009
  - Revised duty on Ofgem: should first consider other measures  
besides promoting competition (Energy Bill Nov 2009)

# Politics: Coalition Govt 2010-15

- Jul 2010 Energy costs likely to rise, so Govt committed to strong regulation
- Review of Ofgem “to ensure that the regulatory framework would deliver against our strategic objectives” and “paramount to keep customers engaged in market”
  - Energy Act 2013: obligation on Ofgem to further delivery of Govt’s policy
- 2011 Sec of State supports Ofgem & proposes more teeth
  - Asks Ofgem “to assess whether competition being hindered by some energy cos that have high energy prices for millions of their consumers & yet offer much cheaper online deals that make it difficult for small suppliers to compete”
- Oct 2012 PM at Question Time: “energy suppliers will be required to put customers on lowest tariff” (→ Cheapest Tariff Messaging)

# Political pressures increasing 2013

- May 2013 Govt takes Energy Act powers to impose Ofgem proposals
  - “urgent aim to keep prices down, time of the essence, this would speed up process”
  - “uncertainty in retail market due partly to length of time Ofgem has been considering reform” [refers to Procrustean Bed proposed then abandoned]
- July 2013 Ofgem: “close collaboration & shared objectives of Govt & Ofgem”
- Sept 2013 Miliband proposes energy price freeze
  - Also simpler tariffs with uniform daily standing charge set by regulator, abolition of Ofgem, and “tough new energy watchdog with power to cut unfair prices”
- Oct 2013 Sir J Major suggests windfall tax on suppliers

# CMA reference as solution?

- Oct 2013 Govt asks Ofgem to do joint review with OFT & CMA
  - “building on existing & planned cooperation between Ofgem & OFT/CMA”
  - Mar 2014 Joint Review published, Ofgem minded to make CMA ref
  - June 2014 Ofgem makes reference to CMA
- But not the last contribution from Govt
  - Aug 2014 Govt Draft Strategy & Policy Statement: Ofgem to deliver “a competitive market in which consumers can easily identify best deals available”
  - Feb 2015 PM’s office considering state-run price comparison website
- Conclusion: Ofgem policy since 2008 heavily influenced by political not economic factors – especially concern about “unfair prices” & need for customers to be active in market

# CMA energy market investigation

- June 2014 CMA energy market investigation
- June 2016 Final Report
- Major Suspects – generator market power, barriers to entry esp lack of liquidity, vert integration – CMA finds Not Guilty
- Main Culprits: Ofgem & DECC
  - Absence of locational pricing for transmission losses
  - Mechanism for DECC allocating CfDs
  - Ofgem's simpler tariffs RMR policy
  - Gas & electricity settlement processes
  - Lack of robustness & transparency in regulatory decision-making
  - Industry codes governance
- These CMA findings seem plausible, & remedies sensible

# CMA retail market analysis

- Customers have limited interest in switching, & face barriers to assessing information & to switching
  - These barriers higher for Prepayment Meter customers
- These features deter & impede customer engagement
- Resulting weak customer response gives suppliers unilateral market power over inactive customer base which they exploit through their pricing policies
  - E.g. Standard Variable Tariffs priced above cost difference from other tariffs
  - E.g. Pricing above level justified by efficient costs
- Remedies include give customer data to competitors, & introduce price controls

# Weak customer response: evidence?

- Survey 7000 customers: CMA claims “material degree of disengagement”, suppliers dispute this interpretation
- Certain customers less likely to have switched supplier
  - Low income, rented social housing, no qualifications, age 65+
- CMA: What would I do if I were a consumer? Ans: Switch
- So unexploited switching gains → weak customer response
- Rather than → CMA doesn't fully understand consumers
- CMA makes no comparison with realistic benchmarks of customer behavior for other products or other countries



# Economists and the horse

“If economists wished to study the horse, they wouldn't go and look at horses. They'd sit in their studies and say to themselves, 'what would I do if I were a horse?'”

(R H Coase citing Ely Devons)



# CMA economists look at 7000 horses, find weak equine response



# CMA and customer detriment

- “10.2 Our approach to assessing the scale of detriment has involved considering to what extent the outcomes that we have observed in the domestic retail energy markets are worse than we would expect to see in a well-functioning market ...
- ... **‘a well-functioning market’ ... is not an idealised perfectly competitive market”**
- “10.27 We have based our assessment on the principle that ... a competitive benchmark price ... (b) should be reflective of the costs of an **energy supplier which has reached an efficient scale** ... and which is **in a steady state** ... and (c) it should generate revenue that is consistent with a **normal return**”
- But isn't this precisely a perfectly competitive market?

# Calculation of customer detriment

- Direct approach: compare prices Big6 & 2 mid-tier (£1.4 bn pa)
  - CMA adjusts mid-tier for environmental cost exemptions & loss-making
  - More plausible adjustments would remove difference in prices?
- Indirect approach: excess profits (£303m pa)
  - CMA uses low benchmark EBIT margin 1.25%
  - But risk-adjusted margin in I&C market (not harmful) is 2.4%
  - Applying I&C standard would remove domestic “excess profit”
- Indirect approach: inefficient costs (£290m or £420m pa)
  - Difference between actual & lower quartile costs of Big6 suppliers
- No economic basis for using cost differentials as detriment
  - All competitive markets have such cost differentials - costs only equal in theoretical perfect competition model
  - Never been used by CC or any other competition authority

# Summary on CMA retail analysis

- CMA is understandably concerned that some who pay higher prices are more vulnerable customers
- BUT wrongly concludes retail market is uncompetitive
- Quantification of customer detriment implausible
  - Benchmark well-functioning competitive market is an idealized perfectly competitive market, rejected by CC/CMA Guidelines
  - Calculations are hypothetical, “excess profits” disappear if I&C market standard used, “excess costs” argument invalid
- More plausible conclusion: customers *Not* being exploited, market does *Not* require everybody to be engaged
- Remedies inappropriate: reintroduction of price controls
- What went wrong? When rest of CMA report seems OK?

# Perhaps I am wrong? But not alone

- Critique developed with other former regulators
  - McCarthy, Marshall, Spottiswoode, Smith (economists)
- Similar concerns voiced by other economists
  - Yarrow, Waddams, Deller
- Informal soundings of other economists don't suggest disagreement
- No economists have written or spoken in support of CMA on this?

# Absence of economists at CMA? No

- CMA has professionally qualified economists at highest level
  - CMA Chair
  - Executive Director, Markets & Mergers
  - Chief & Deputy Chief Economic Adviser
  - Panel Chair (who is also an Inquiry Chair, CMA Non-Exec Director & Chair of energy inquiry)
  - 2 of 7 other Inquiry Chairs including one member on energy inquiry
  - Project Director of energy Inquiry
  - 7 Economics Directors

# Politics & CMA energy inquiry?

- Continued strong concern about energy prices
  - Increasing pressure to Do Something
- 2007-10 Focus on behavioural economics
  - FSA, Ofgem, OFT, Nudge Unit, CC/CMA
- Apr 2011 Govt policy “more proactive interventions to accelerate shift to more informed consumers” (Better Choices)
- 2011-13 CMA “to play leading role in achieving [Govt’s] overarching objectives & delivering desired outcomes”
- 2013 Govt Steer on how CMA should support Govt’s priorities
  - It should investigate the energy sector (amongst others)
  - It should make consumer behavioural issues central to CMA analysis
  - It should work with sector regulators (Ofgem)



- “It is a truth universally acknowledged, that a chairman in possession of a large competition authority, must be in want of advice from the Government.” (Jane Austen)



# Change in Govt view of role of competition authority?

- CC Role

- Is there a problem?

- What should be done about it?

- CMA Role

- Here's the problem

- Here's how to analyse it

- Fix it

- Now

# Developments since CMA creation

- CMA has emphasised behavioural economics
  - eg Chair/CEO speeches
- CMA did accept energy reference,
- Energy panel did make consumer behavioural issues central to its retail analysis,
- Energy panel cooperated with Ofgem,
- & Energy panel Fixed It by remedies including price control

# The CMA's future?

- 2016 Govt Consultation “to deliver quicker competition outcomes” & “improve inquiry group accountability to CMA Board”
  - ‘Professionalise’ panel: fewer but more engaged members, or members from regulatory bodies or from CMA staff
  - Shorter appointments to allow better scope for performance management
- Acknowledges “concern about reduced independence of inquiry group” and “panel not sufficiently independent of CMA Board or its policies”
- Govt priority not improving quality of analysis, but for CMA to Fix problems even more quickly

# But on the other hand ...

- No evidence of actual Govt pressure on CMA?
- Or of CMA Board actual pressure on panels?
- CMA speeches on behavioural economics balanced
- Critique doesn't apply to rest of CMA energy inquiry
- CMA banking inquiry not subject to same concerns?
- All suggests that retail energy market is sui generis?
- Why?

# Four factors in retail energy?

- 1 Behavioural economics now embedded in Govt, regulators & CMA?
  - Disproportionate to econs profession?
  - Finding weak customer response inevitable?
- 2 CMA working closely with Ofgem
  - Judge asked to work with police who turn out to be mafia?
  - Whether or not justice was done, not seen to be done?
- 3 Did their backgrounds make economists on Inquiry esp sensitive to concerns about “unfair” energy prices?

# 4 Panel's view of energy retailing

- Did panel have rather dismissive view of energy retailing?
  - “Energy retailing is just metering and billing.”
    - (R Witcomb *D Tel* 23 June 2016)
  - “Most of the costs are straight pass-through. ... There’s no capital in this market.”
- “Is this an appropriate market to open up to competition?”
  - “Somebody ought to go back and have a look at the market given the difficulties we have around the cost of customer engagement and that everybody has to be engaged in order for it to work properly.” (R Witcomb *Utility Week* 2 Sept 2016)
- Unclear whether personal or group view, before or after investigation
- But does it help to explain (not justify) treatment of retail market?

# Six challenges for economists

- How to get economics back into Ofgem retail policy?
- How to ensure CMA is “firmly based on sound economics”?
  - “There is an almost smug consensus that competition assessment now is firmly based on sound economics. It certainly was not always so, and could, I suppose, cease to be so.” (Peter Freeman, Beesley Lecture, 2009)
- How to rescue retail energy market from Ofgem & CMA?
- How to get benefits of competition to vulnerable customers?
- How to combine behavioural insights & sound economics?
- How to ensure the opening of the retail water market is characterised by sound economic analysis and policy?