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Dear Dermot

We write following the Secretary of State's letter to you of 21 June 2017 and Ofgem's published statement in response.

The Secretary of State notes that various political parties have proposed price protection for various types of energy consumers. He suggests that endorsement of "this approach" by the electorate constitutes good reason to proceed without delay. However, the party manifestos proposed more than a dozen different energy measures, including many to assist customers. At least two parties did not advocate a price cap (one of these parties reportedly describing the Conservative policy as "pure economic illiteracy"). And several parties proposed price protection simply as a transitional stage to reintroducing public ownership.

We therefore suggest that Ofgem, guided by its statutory duties and by the evidence available, should first consider carefully whether there is in fact a case for further restrictive regulatory intervention.

Real and plausible customer detriment – or not?

In urging rapid action, the Secretary of State refers to the CMA's calculation of customer detriment averaging £1.4bn year. Other advocates of price caps have used the same justification. This suggests a widespread belief that the CMA found that the six large energy suppliers made excess profits of that amount. This is understandable, since that is what such a competition authority finding would normally imply. But as you will know, this is *not* what the CMA's £1.4bn calculation refers to.

In principle, the CMA's calculation involved "comparing the average prices charged by the Six Large Energy Firms with a competitive benchmark price which is based on the prices charged by the most competitive suppliers." (CMA *Final Report* 2016 para 10.5) This benchmark was acknowledged to be "a hypothetical construct, a 'supplier' that is a combination of the suppliers that we have identified as being the most competitive in the markets." (para 10.18)

It soon became apparent that the large and smaller suppliers were not directly comparable, and the CMA had to make a series of major adjustments to the latters' prices. The CMA ended up comparing actual prices of the six large suppliers with the CMA's guess at what just two of the much smaller mid-tier suppliers would charge *if* they were not exempt from costly environmental obligations and *if* they had reached an efficient scale and *if* they were in a steady state and *if* they were not loss-making and *if* instead they were earning a normal return on capital. It was a comparison with a purely hypothetical alternative that was simply assumed to be more efficient.

Not surprisingly, the result was implausible and the calculation was heavily challenged by the suppliers. For example, the alleged customer detriment averaging £1.4 billion per year was significantly greater than the average aggregate domestic retail margin that the six large suppliers earned during this period. The latter was of the order of £1 billion per year, before any return on capital. According to the CMA's criterion and calculation, the six large suppliers could only have avoided imposing a customer detriment by operating at a loss. To the best of our knowledge, no competition authority has ever used such a hypothetical and implausible construct for assessing supplier conduct or customer detriment.

Excess profits – or not?

As you know, the CMA did make a separate calculation of excess profit, as part of its 'indirect' approach. It calculated that the Six Large Suppliers' total net revenues, less a normal profit assumed to be a 10 per cent return on capital, averaged £303 million per year over the period 2007-2014.

As with its 'direct' approach, the CMA made numerous significant assumptions and modifications, which again were challenged by the suppliers. But even taken at face value, £303 million is much less than the cited £1.4 billion, and it amounts to only about £12 on a dual fuel bill of around £1000 per year. However, this aggregate figure conceals very significant differences between the six large suppliers. These are not apparent in the CMA report because of the very extensive redactions therein.

Consider therefore the evidence from the published Consolidated Segmental Statements of the Six Large Suppliers, the content and format of which Ofgem itself has prescribed. Over the period 2009 – 2014, two of the six large energy suppliers had average profit margins (ratio of EBIT to revenue) that were in the range 5 -7 per cent, two had margins around 1.5 per cent, and two consistently made losses.

The CMA calculated that a 1.25% EBIT margin provided a reasonable competitive benchmark for a large standalone energy supplier with a trading intermediary. It said that this corresponded to about a 2% EBIT margin for a more capital intensive business model as operated by the six large energy suppliers. (Appendix 9.10 paras 158-9)

In other words, four of the six large suppliers operated on profit margins lower than the CMA considered competitive, and two of them actually made losses. In contrast, the largest supplier accounted for no less than two thirds of total retail profits. The largest two suppliers together accounted for 95 per cent of the total profits.

There may be arguments about the detail of these figures and appropriate adjustments. Some would consider the CMA's 2% EBIT margin unduly severe. And there may be scope for discussion as to how far the higher profits of two suppliers are attributable to incumbency advantages or to superior efficiency.

But for present purposes, the important point is that any alleged excess profit in this sector is not an across-the-board phenomenon characterising all suppliers: if there is any excess profit (which some would challenge) it is associated with one or at most two suppliers. It cannot therefore be attributed to some phenomenon common to all suppliers, such as alleged weak customer response. It does not indicate a lack of competition in the market as a whole. And price caps or other interventions applying indiscriminately to all six large suppliers cannot be justified on the basis of alleged excess profits in the energy sector.

Absolute price caps – or not?

The CMA considered carefully the possibility and implications of imposing price caps on the six large suppliers, and specifically on their standard variable tariffs. It pointed out quite explicitly that its calculated customer detriment was *not* based on excess profits, and that this had implications for appropriate remedies.

> "A large part of the detriment we have observed in the form of high prices is likely due to inefficiency rather than excess profits, such that if we were to eliminate the entirety of the detriment we have observed through a price cap it would create substantial losses for the sector as a whole." (para 11.90)

In its *Provisional Conclusions*, the CMA had considered a wide range of remedies, in the light of extensive consultation responses. It explicitly rejected the possibility of extending a price cap to all standard variable tariffs. As you know, the CMA's *Final Report* reaffirmed this view:

> "The majority of us concluded that the disadvantages of attempting to address the detriment of all SVT customers through a price cap would exceed the benefits, believing that attempting to control outcomes for the substantial majority of customers would – even during a transitional period – undermine the competitive process, potentially resulting in worse outcomes for customers in the long run. This risk might occur through a combination of reducing the incentives of customers to engage, reducing the incentives of suppliers to compete, and an increase in regulatory risk." (para 11.86)

> "The majority of us considered that once the principle of such a highly interventionist remedy to deal with weak customer engagement is established, it inevitably increases the risk of further such interventions in the future, with ongoing harmful effects on engagement and supplier incentives." (para 11.88)

Last week, Roger Witcomb, chairman of the CMA energy investigation, reiterated these conclusions. We share his view and that of the CMA group on this central policy issue. Imposing a loss-making price control on companies on the grounds that these companies are alleged to be inefficient does not seem a desirable precedent for the energy sector or for the UK economy generally.

We note that Professor Martin Cave dissented from the CMA majority view, on the basis that the calculated customer detriment was very severe, and a price cap was needed to remove a significant part of that detriment. The Secretary of State also cites the CMA's customer detriment calculation as justifying urgent action. For the reasons set out above, we do not accept that the CMA's calculation reflects a real and plausible customer detriment. If the CMA itself, which believes in that customer detriment calculation, nonetheless also believes that a price cap would be inappropriate, then any question about the validity of the CMA's calculation surely weakens further the case for such a price cap.

Relative price caps – or not?

In 2008 Ofgem alleged that the market was characterised by "unfair price differentials", by which it meant price differentials that were not "objectively justified by cost differences". For example, former electricity incumbents charged higher prices to customers inside their former monopoly areas than to customers outside those areas. Ofgem argued that more engaged customers who switched supplier were protected by competition but less engaged customers who stayed with their incumbent supplier were not protected by competition. It claimed that price differentials indicated that suppliers were exploiting market power.

In an attempt to protect the less engaged customers, Ofgem introduced a non-discrimination condition to prohibit such price differentials. Independent economists warned strongly against this, and they were right. The outcome has been well documented. The CMA found that "when Ofgem prohibited suppliers from offering out-of-area discounts for new customers, the effect was to increase prices for out-of-area customers and reduce the strength of competition". (para 14.44)

In its own investigation, the CMA, too, found price differentials. It concluded that large suppliers were exercising unilateral market power "through price discrimination by pricing their standard variable tariffs materially above a level that can be justified by cost differences from their non-standard tariffs". (para 160) Like Ofgem, the CMA argued that those customers who engaged in the market were protected by competition, but those customers who did not engage were not protected.

However, the CMA, noting the adverse consequences of the previous non-discrimination condition, did not advocate such a remedy. In discussing the PPM price cap, it observed that approaches of this (non-discrimination) kind "lead to excessive risks of perverse supplier incentives and harmful impacts on competition" (para 14.46). Instead, the CMA focused on measures to increase customer engagement.

Some have argued recently for a relative price cap, to tie each supplier's standard variable tariffs to its fixed tariffs. This would be in effect another non-discrimination condition. It would therefore be subject to the disadvantages that the CMA identified. It would benefit the smaller and medium suppliers by handicapping the larger suppliers, and any benefit for customers on standard variable tariffs would be largely at the expense of customers on fixed tariffs. It would likely reduce customer switching, thereby dampening competitive pressures to the disadvantage of all customers. We therefore agree with the CMA that relative price caps would not be a desirable policy.

Unfair price differentials – or not?

However, our concern about relative price caps is a more fundamental one: like absolute price caps, they assume the existence of a problem that is not consistent with the evidence.

Ofgem and the CMA considered that observed price differentials were unfair and indicative of the exploitation of market power. Yet an extensive economic literature explains that price discrimination can indicate competition rather than market power. Differential mark-ups over cost can be optimal or more efficient than uniform mark-ups. Price discrimination can be a means of competing and of intensifying competition. In some circumstances, firms have no choice: the pressure of competition can force them to discriminate, simply to survive.

The retail energy market appears to be such a case. Retail suppliers are driven by competition to reduce prices to the most active customers (to try to keep those existing customers most prepared to switch, and to try to attract replacement customers from other suppliers). Prices to active customers are thereby driven down towards marginal operating cost. So suppliers have to try to recover their overhead costs (as well as operating costs) from their less active customers. But all their tariffs are subject to competition because all customers can switch.

Ofgem's data indicate that the six large suppliers in aggregate did not manage to recover their operating costs plus overhead costs for the three years 2005-2007. (Ofgem, *Electricity and Gas Supply Market Report*, June 2010) The discussion above has explained why the market has not been characterised by excessive profits over the subsequent period. In other words, price differentials have not been a means of exploiting market power to make excess profits. On the contrary, they have been a means of intensifying competition.

Thus, although it is the case that less engaged customers are paying higher prices than more engaged customers are, these are not "rip-off prices". The less engaged customers are not being exploited. Competition has ensured that, in aggregate, their prices broadly match the cost of supplying them, without allowing excess profits to suppliers. A customer that chooses to be more active could get a better price, but there is no need to urge customers generally to be more active, let alone compel them to engage. The competitive market is already working.

Real concerns

We have argued that the domestic retail energy sector is not characterised either by excess profits or by differential prices that indicate market power. Neither absolute nor relative price caps are justified. There are, however, two potential causes for concern in the sector.

The first is the significant and continuing increase in energy prices over time. Since the early 2000s, domestic energy prices have roughly doubled. It is entirely understandable that customers, politicians and the media are concerned about this, and ask what is going on.

Our understanding, based on publications by Ofgem and the CMA and other studies, is that, from the early 2000s to about 2008, the major reason for the price increases was an increase in wholesale costs, driven mainly by movements in world energy prices. Subsequently, from about 2008 to date, the main reason has been an increase in the costs of transmission and distribution networks and in environmental and social costs. The level of retail profits has *not* been a significant contributory factor during this period.

We therefore urge Ofgem to give priority to explaining previous and prospective energy price increases. We also welcome the Conservative party manifesto commitment to an independent review into the cost of energy, to ensure that UK energy costs are as low as possible, consistent with maintaining reliability and meeting the 2050 carbon reduction objective.

The second potential concern is that some vulnerable customers may have difficulty in paying their increasing energy bills. For various reasons they may not be able to take full avantage of the lowest prices that the competitive retail market has to offer.

We are aware that much has been and is being done in this area. Ofgem has long played an active role in assisting such customers and has further measures in train. Until the late 2000s, suppliers offered various social tariffs. Government has several schemes including the Warm Home Discount and the Winter Fuel Payment. Local authorities are beginning to participate more actively in the market, including with a view to helping vulnerable customers. Nevertheless, it is possible that more could be done in all these respects.

We also urge Ofgem to consider whether any of its present restrictions might be having an adverse effect on vulnerable customers. For example, do the various requirements with respect to best standard variable tariff unduly limit competition via such tariffs? Do the restrictions on direct marketing and price comparison websites limit the ability of third parties to advise and assist vulnerable customers? Do any restrictions or policy guidelines to encourage switching prevent or discourage suppliers from rewarding customer loyalty?

Conclusion

The Secretary of State has asked Ofgem to advise on what action it intends to take in three respects, namely, safeguarding customers on the poorest value tariffs, ensuring that micro businesses are fairly treated, and considering the future of standard variable tariffs. We have not commented previously on micro business issues and do not do so here.

As regards poorest value and standard variable tariffs, we urge that Ofgem consider carefully the need for any action and the nature of such action. We have argued that there is not a case for action in respect of excess profits or price differentials. Rather, there is a need for Ofgem to explain why, in both respects, the retail market is actually operating competitively.

As regards the nature of any future regulatory action, the CMA's report contains a damning indictment of regulatory interventions since 2008, finding that they have had an adverse effect on customers and competition. Rather than give priority to yet more such regulatory interventions that could be unintentionally harmful, we urge Ofgem to consider first whether the removal of any existing interventions would be more conducive to safeguarding vulnerable customers and making standard variable tariffs more attractive.

Yours sincerely

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