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Snakes and Ladders: price controls and markets. What might the CMA's provisional findings mean for retail markets in utility services?

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Opening remarks

The Competition and Market Authority (CMA) has decided to extend its energy market investigation by six months. Part of its project has gone seriously awry. Its provisional findings that the wholesale markets and vertical integration are not problematic have not really been challenged. Its analyses and possible remedies on renewables subsidies, settlement systems, locational pricing and governance have prompted constructive discussion. But its analysis and possible remedies for the retail market have provoked substantial criticism.

Part of the CMA's analysis here is widely accepted. The CMA finds that Ofgem's policies since 2008, on regional non-discrimination and simple tariffs, have had an Adverse Effect on Competition, and should be discontinued. Ofgem accepts this. Just pause a moment: this is the most damning indictment of a utility regulator in any sector since privatisation and regulation began. A regulator with a duty to promote competition has been found to have spent the last seven years undermining it, and continues to do so today.

The flaw in the CMA's subsequent analysis is partly that it fails to appreciate the implications of its own finding: it fails to realise or acknowledge how far regulation has distorted prices and profits in the domestic market. More seriously, the CMA reproduces Ofgem's own faulty and non-economic diagnosis of this market. It reaches the same conclusion, that the market is not competitive and regulatory intervention is needed, but explores more drastic intervention because Ofgem's medicine was not strong enough. Just as Ofgem's interventions undermined the competitive market, so too will the CMA's.

The CMA's first step is to claim that the domestic energy market is characterised by weak customer response. It bases this on a purely imaginary "well functioning market" that reflects wishful thinking. It bears no relationship to actual retail energy markets as they operate around the world, or indeed to other markets. The CMA resolutely refuses to look at such real-world comparators.

A simple example of the CMA's approach is its assumption that price should be the main determinant of customer choice. This is evidently inconsistent with evidence that some customers do not switch supplier despite high price differentials. But instead of concluding that its assumption is incorrect, the CMA deduces that it's the customers who are wrong and need to be corrected.

Nor is the CMA's characterisation consistent with the evidence before it. One might expect the major suppliers to challenge, as they do, the CMA's characterisation as "flawed". But their phrases such as "not supported by the evidence", "largely disregarded the evidence", "selective and in places misleading" tell another tale, relating to professional competence.

The CMA finds differences in prices and engagement levels that it deems inconsistent with a well-functioning market. There is scant understanding of the price differences that characterise real

competitive markets, and little recognition that regulatory restrictions may have played a part in this sector. Since 2008 Ofgem's restrictions on prices and on direct marketing have reduced the customer switching rate to half its previous level, and undermined competition between variable tariffs, with particularly adverse effect on customers that used to rely on direct marketing. Supplier profits have increased by about £1 billion since 2008. The CMA ignores these regulatory impacts and declines to consider further the direct marketing restrictions.

The CMA's next step is to calculate how far major suppliers have exploited the allegedly weak consumers. It finds that they have done so to the extent of about 5 per cent, amounting to about £1.2 billion per year. Its methodology and calculations are obscure in the extreme, even to those permitted into the secret data room. Again, suppliers might be expected to find significant flaws in the analysis, as they do. More serious for the CMA are their criticisms of "assumptions of perfect foresight", "internally inconsistent assumptions producing wholly implausible outcomes", "unrealistic" analysis "not reflective of market realities", and "assumptions inconsistent with commercial reality".

How does the CMA square its claim that domestic customers have been overcharged by about £1.2 billion with the fact that supplier profits in the domestic market have barely averaged £1 billion in recent years? It seems – though no one can be sure – that the CMA assumes that at least half of the overcharging reflects not excess profits, but supplier costs that are higher than they would be in a well-functioning market. It seems – though again it is unclear – that all suppliers are expected to have the same costs as the lower quartile supplier. So some of the major suppliers are wantonly failing to take obvious opportunities to reduce their costs? The CEO of a major supplier recently lost his job because his company profits were not adequate. Does the CMA know something about cost reduction that eluded him?

One of the CMA's possible remedies is that Ofgem should provide a price comparison website. The claim that this would increase consumer trust in other comparison websites is implausible. There is barely any recognition that Ofgem might not have the necessary resources or expertise, and that this involvement might distort the market and its regulation. The Secretary of State conjectured that this proposal was not well thought through, and she was right.

Two more possible remedies are to provide customers with more information and to prompt customers to engage. These are little more than a series of questions, with apparently little hope of receiving persuasive answers.

The CMA's key possible remedy is to prohibit the "evergreen" standard variable tariff which about 70 per cent of domestic customers have presently chosen, or chosen not to leave. Is it not remarkable that controversial products such as alcohol, tobacco and gambling are allowed to be sold but the standard variable tariff is so harmful to customers that it must be prohibited?

But these are the wrong kind of customers: they don't devote sufficient attention to engaging in the energy market, and their preferences should not count. Under this remedy, customers who fail to engage in the market despite the CMA's prompts will be "rolled on" – that is, forcibly transferred - to a "safeguard tariff" with a maximum level set by the CMA or Ofgem.

The CMA conjectures that such a price control will not discourage competition because the safeguard tariff will be set above actual costs to include some “headroom”, as used in New South Wales. The CMA is “currently reviewing that example” to understand its impact on the market. One might have thought that the CMA would review that example before suggesting it rather than afterwards. The NSW regulator used that approach only briefly, as a means of abolishing a price control that was holding back competition. The CMA’s subsequent questions show that, here again, it has not thought through the implications of what it suggests.

Ofgem is somewhat circumspect about the CMA’s possible remedies, but says “We strongly agree with the CMA’s analysis on weak customer response and the presence of unilateral market power over inactive customers”. This is not surprising. Ofgem and the CMA both have the same approach to this market. This is characterized by an imaginary rather than real market benchmark (what Ofgem called a “vision”), by benchmark companies in static long-run equilibrium rather than in a dynamic process of rivalry, by imagined or desired rather than observed customer preferences, by substituting their own preferences for those of customers, by selective use of the evidence, by a blurred distinction between how markets actually work and how these bodies would like them to work, by a willingness to favor some consumers at the expense of others without a clear statutory basis for doing so, by a cavalier attitude to interventions in the market, by a failure to acknowledge the extent of the adverse consequences of such interventions, and by imperviousness to professional economic advice and warnings. This approach is constructed in what is essentially an Economics-Free Zone.

This stands in contrast to Ofgem’s approach in other parts of the energy sector, and to the CMA’s approach both there and in other sectors. Elsewhere, both organizations generally do high quality work and are well respected at home and overseas. But in the domestic retail energy market both organizations seem to perceive an overwhelming need to Do Something, and the analysis has suffered as a result.

The logic of the CMA’s analysis and possible remedies points towards more intervention and the introduction of price controls in other sectors where customer engagement and trust are reportedly lower and/or where price differentials are reportedly higher. Banking, insurance, telecommunications might be candidates – indeed, any sector where customer loyalty or even brand loyalty might threaten an approved level of customer engagement.

I hope the CMA will rethink. Its present analysis suggests a CMA that does not believe in competition and does not understand markets, but has a disconcerting faith in authority. These are not the characteristics of a well-functioning competition authority.