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The CMA's analysis of the retail energy market: an examination using textbook economics

EPRG Working Paper 1703

Cambridge Working Paper in Economics 1707

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1. Following public concern about energy price increases, Ofgem referred the energy market to the Competition and Markets Authority (CMA) in 2014. The CMA reported in June 2016. This paper is concerned with its analysis of the domestic retail market. The CMA found that "weak customer response" gave suppliers market power, which they used to price discriminate (setting prices of their Standard Variable Tariffs above their fixed tariffs by more than the difference in cost of providing these tariffs) and/or by setting prices above the cost of operating an efficient supply business.

2. The CMA used two approaches to estimate the detriment to customers. Its direct approach compared the average prices charged by the Six Large Energy Firms (SLEFs) with the price charged by the most competitive suppliers. Its indirect approach calculated and added the excess profits of the SLEFs and the extent to which their costs were inefficient. These approaches yielded estimates of detriments of around £1bn to £2bn per year over the last few years.

3. The aim of this paper is to use simple textbook economics to understand better the nature and implications of the CMA's calculations.

4. Economists have shown that price discrimination is not necessarily an indication of market power. Where there are economies of scale, it can be an efficient way to recover overhead costs, and consistent with a competitive market. The CMA acknowledged this, and defended its criticism of the practice by the claim that that "on average, customers have been paying prices that are above the competitive level". What, then, is "the competitive level", and have prices in fact been above it?

5. The most famous diagram in economics shows price determined in a competitive market by the intersection of the market supply and demand curves. This is what is conventionally meant by a price at "the competitive level". In such a competitive market, there is zero excess profit on the last unit produced

(price is equal to cost plus a normal profit), or for the highest cost producer. However, more efficient lower cost suppliers make a profit – sometimes called producer surplus. This is different from the "true" excess profit that arises if suppliers are able to exercise market power and raise prices above the competitive level.

6. Using its indirect approach, the CMA estimated that what it called excess profit averaged about £303m per year over the period 2007-2014. Unfortunately the CMA did not distinguish between producer surplus and true excess profit.

7. Published data shows considerable variation between the costs of the Six Large Energy Suppliers. This suggests that a significant proportion of the CMA's calculated excess profit would be producer surplus and not true excess profit. The data also indicate economies of scale.

8. The data also show significant differences in profitability between the suppliers. Two of them made a loss on average throughout the period 2009-2014. This suggests that tariff prices in the market were if anything below, rather than above, the competitive level. Differences in prices between the suppliers do not change this judgement.

9. The second part of the CMA's indirect approach was a calculation of inefficient cost. This is a problematic concept, first suggested by Ofgem's Probe investigation in 2008. It seems to assume that costs converge over time to "the competitive level", but that level itself does not change over time.

10. The CMA calculated its inefficient cost by comparing suppliers' actual indirect costs per customer with a benchmark equal to the lower quartile of the large suppliers' costs. It also explored other benchmarks such as the lowest cost large supplier and two mid-size suppliers.

11. The idea of adding alleged excess profit, most of which seems to be producer surplus rather than true excess profit, plus inefficient cost, does not seem to have been previously used in competition policy analysis. However, it suddenly becomes familiar if another supply curve is added to the textbook diagram. The calculation then measures the savings to customers if there is a downward shift in the demand curve in a competitive market.

12. What this means is that the CMA's calculations are not about customer detriment as a result of market power in the conventional sense of excess profits resulting from prices above "the competitive level". They are about the benefits to customers of a hypothetical reduction in suppliers' costs.

13. The CMA in fact says as much. "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." In other words, the CMA is not claiming that the six large suppliers are overcharging in relation to their present costs. The CMA's

argument is that their costs should be lower. Thus, the CMA's findings do not mean what they are generally taken to mean.

14. Thus, the CMA has not demonstrated market power in the conventional sense. If anything, prices seem to be below, rather than above, the competitive level. Similarly, the CMA has not demonstrated that price discrimination is a reflection of market power. On the contrary, it seems to be a means of competing. And if prices have been below the competitive level, in what sense has customer response been weak and had an adverse effect on competition?

15. The CMA argues that weak customer response has meant less pressure on suppliers to be efficient. But how was it also so strong that suppliers could not set prices above the competitive level? Should weak customer response be responsible for other factors possibly affecting efficiency, such as regulatory interventions and public ownership of one supplier? Why has the capital market not functioned to discipline efficiency (by replacing management in order to make profits instead of losses)?

16. These and other questions will be for the CMA as an organisation to ponder if it is going to continue to compare actual companies against hypothetical companies operating at "the efficient level" – and, more generally, against a benchmark well-functioning market that can be more or less anything that a CMA panel would like it to be. Of more immediate concern is that the ambiguity in the CMA's energy market report has stimulated proposals for further government and regulatory interventions that are not justified by the report, and would be inconsistent with the CMA's wish to increase competition as a means of increasing efficiency.

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Publication March 2017
Financial Support