

Rachel Reeves MP, Chair  
BEIS Select Committee  
House of Commons

18 December 2017

Dear Chair

Thank you for inviting us to give evidence last Tuesday. We appreciated the thorough and courteous questioning and hope that our evidence will be of value in your inquiry.

In your final summing up, you highlighted two issues of particular concern that merited further examination: the robustness of the CMA's £1.4bn customer detriment figure, and frustration about the energy market, particularly prices and the high number of customers still on Standard Variable Tariffs (SVTs). In the light of exchanges during Tuesday's session, may we offer a few further observations on those two issues? In so doing we also clarify a question that was put to us about access to the CMA's data room.

## **1 The CMA's £1.4bn customer detriment calculation**

### **1.1 Oxera report**

Besides our own critique of the CMA's £1.4bn detriment calculation, we drew attention to Oxera's contribution. The CMA, in response to questioning, explained that there were many challenges from the companies and the CMA had to decide what assumptions to make. This is understandable. But we draw the Committee's attention to two points.

First, this is not a matter of fine detail. Oxera argued that the correct figure could be anywhere between £0.7bn (half of the CMA's estimate) and minus £0.7bn.

Second, Oxera estimated that adjustments of £1bn were made after the data room closed, so could not be scrutinised by anyone. This point has not been rebutted.

### **1.2 Access to the data room**

We were asked whether we formally requested permission to access the CMA data room and whether this was refused. The answer is Yes on both counts. On 11 March 2016 we emailed to the CMA as follows:

I write on behalf of the five former energy regulators who have made various submissions to the CMA energy investigation. In order to make better informed representations to the CMA, we should like to understand better the composition of excess charges, especially the split between excess profit and inefficient costs. We are interested only in the averages, not in the confidential detail for each company. It is not clear from statements to date whether these averages will be made public in the full Provisional Remedies to be issued next Thursday.

In the event that the component averages are not to be made public, we should be interested to access the data room, either ourselves or a financial adviser on our behalf. Could you please advise whether that would be acceptable, and on what basis?

On 15 March the CMA replied as follows:

I write further to your e-mail of 11 March to my colleague [ ], in which you enquired about accessing the Provisional Decision on Remedies (PDR) data room to review information in relation to excess charges and the split between profits and inefficient costs.

The published version of the PDR will contain information on the overall level of excess profits and our measures of inefficiency. The details will be included in the detriment section and in appendices 3.4 and 3.5.

Access to data rooms and confidentiality rings is generally limited to the external legal and/or economic advisers of parties who may be affected by the outcome of the investigation and is provided to ensure a fair process and parties' rights of defence. We therefore do not consider at this stage that there are strong grounds to justify extending access to former energy regulators or their financial advisers.

In the event, the numerical details in the detriment section and in the mentioned appendices were excised. So, for example, Appendix 3.5 Annex A referred to concluded as follows:

34. Based on our analysis we have found that:

- (a) [redacted];
- (b) [redacted]; and
- (c) [redacted].

As mentioned in our initial submission, the CMA's final report contained over 10,000 such excisions.

### **1.3 The Competition Commission's Cement report**

Reference was made to the Competition Commission [CC] report on the cement industry.<sup>1</sup> It was suggested that that report had adopted a similar approach as the CMA in calculating customer detriment. In fact, there was a critical difference. Using a standard approach, the CC calculated excess profit averaging £30m per year over 2007-2012. The CC also made a calculation (although it did not rely on it) based on "comparing average cement prices with a benchmark price that would prevail in a well-functioning market (the 'cost-based approach')". (para 8.412) The cost-based approach was as follows.

To establish our benchmark price, we have derived a competitive supply curve of cement. The competitive supply curve is derived from producers' costs of supplying cement. In a well-functioning market, the interaction of competitive supply and demand would be expected to establish a market-clearing, competitive price of cement. (Appendix 8.6 para 11)

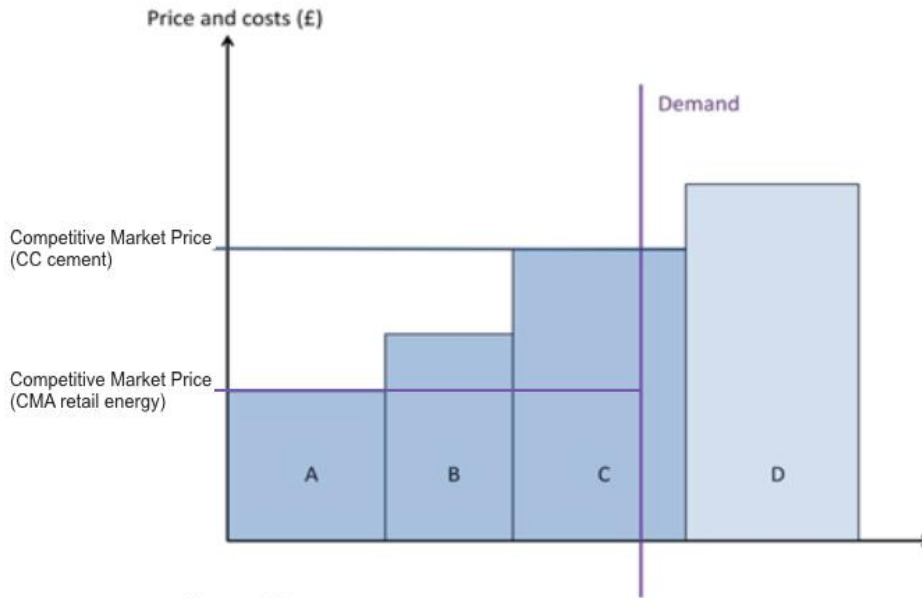
This competitive supply curve was based on the companies as they actually existed: "we took existing cement works' capacities and costs as given". (para 15) Figure 1 from the CC report (Appendix 8.6 page 8, reproduced below) shows how the CC estimated the competitive market price by choosing plants in increasing order of unit operating cost and identifying the *highest cost* plant C that was needed to meet the demand. The CC's estimated consumer detriment was then based on the extent to which the actual price in the market exceeded that calculated competitive market price. This is in accord with conventional economic practice.

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<sup>1</sup> Competition Commission, *Aggregates, cement and ready-mix concrete market investigation, Final report*, 14 January 2014

FIGURE 1

**A supply curve, a demand curve and the marginal plant**



In contrast, the CMA did *not* base its calculations on energy suppliers’ existing capacities and costs. It may have started with the notion of basing its calculations on the actual prices and costs of two mid-size suppliers. But these suppliers were an order of magnitude smaller than the Big 6 suppliers. In the event, the adjustments the CMA made to try to ensure comparability were so significant that it ended up basing its estimates on a purely hypothetical supplier “at an efficient scale” and “in a steady state”. In effect, the CMA assumed that *all* suppliers’ unit costs were equal to that of the *least* cost plant, analogous to plant A in the CC’s Figure 1 except that it was largely hypothetical. So the CMA’s calculated competitive market price (which we have added to the CC’s Figure 1 above) was based on a hypothetical cost of the lowest cost plant in the market instead of the actual cost of the highest cost plant that was needed in the market. At the CMA’s calculated price, customer detriment was inflated and almost all companies in the market would make losses.

The CMA’s calculation of customer detriment in the retail energy market is thus inconsistent with the CC’s approach in the cement case. By looking only at hypothetical costs instead of actual costs, by assuming suppliers should have been more efficient than they actually were, and by ignoring actual capacities, the CMA significantly underestimated the competitive market price. This meant that it significantly over-estimated the customer detriment in the retail energy market. Thus, in our opinion, the CMA’s £1.4bn calculation is not an indication or confirmation that “the energy market is broken”. Rather, it is a consequence of an erroneous approach that is inconsistent with previous UK Competition Commission analysis. (And it is an approach that could have worrying implications for other sectors if price controls can be proposed based simply on an assumption that companies are inefficient.)

#### **1.4 Do suppliers challenge the £1.4bn detriment calculation?**

It was suggested that perhaps the suppliers did not strongly dispute the CMA's calculation of £1.4bn customer detriment because they had the opportunity to legally challenge it but did not do so. However, advice to us was that it is possible to challenge the CMA's remedies but not its analysis per se. If the suppliers were prepared to accept the CMA's remedies – which did not involve a price cap on SVTs - that may have foreclosed their option to challenge the CMA's analysis. We therefore urge the Committee to explore the views of the suppliers and others on the CMA's customer detriment analysis and calculation.

#### **1.5 Implications for possible price control on SVTs**

Professor Cave and Mr Thornton both made the point in their session that setting a price control to remove a detriment of £1.4bn would not be consistent with meeting all five conditions of clause 1(6). We entirely agree.

To balance these five conditions, some lower targeted price reduction would be necessary. If a detriment is to be claimed, and a price cap to be introduced, our view is that it would be more consistent with UK competition policy to base the case for it, and any targeted reduction in prices, on the conventional concept of excess profit. This is not to say that we accept the CMA's calculation of excess profit averaging £303m per year, or the need for a price cap. Nonetheless a price cap that aimed to reduce SVTs or other default rates by about £303m could be consistent with the five conditions of clause 1(6). A targeted reduction of £1.4bn would not be.

### **2. Frustration about the energy market and Standard Variable Tariffs (SVTs)**

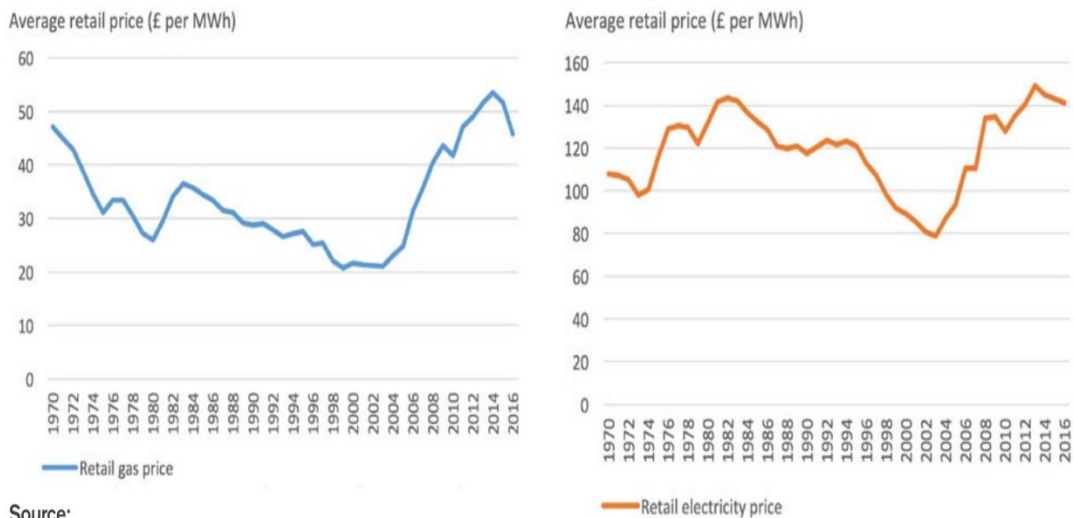
#### **2.1 Increasing energy bills**

During the first session, Mr Coaker expressed his frustration with the energy market. He said that customers feel that the competitive market does not work for them, their energy bills keep going up, and the market seemed unfair because Standard Variable Tariffs were priced higher than other tariffs.

We entirely understand and sympathise with the concern about energy bills. Figure 1.3 from *Ofgem's State of the Energy Market Report 2017* shows that domestic energy bills steadily decreased for two decades during the 1980s and 1990s, but increased sharply from about 2003, with only a limited reduction in the last year or two.

We pointed out during the session that this increase in energy bills was not in general the fault of retail suppliers. *Ofgem's Report* (Figure 1.4 p 15) shows that retail supplier pre-tax margins accounted for only 4% of the average domestic dual fuel bill in 2016. Rather, the increase in bills variously reflected increases in international fuel prices, the increasing costs of transmission and distribution networks and, most recently, the increasing costs of Government-prescribed schemes for environmental and social purposes.

**Figure 1.3** Average retail energy prices: 1970 to 2016



Source:

BEIS, Annual domestic energy bills data, 2017.

What does this mean for the future? We draw attention to the submission to this Committee by Cornwall Insight.

28. Regardless of the actions taken forward on any wider price caps, we do not necessarily believe they will act to reduce electricity bills. These bills in particular will continue to increase in the coming years due to rising costs of policy. Without further efficiency savings, including inflation, we forecast a further £90 on domestic bills by 2021-22 in third party charges for networks, generation, energy efficiency and smart [meters] .... This is equivalent to 15% of the total electricity bill as of now.

29. It is essential that the formula for an absolute price cap is able to accommodate these increases. Setting the cap is likely to become an exercise in signing off bill increases, and there is the potential for the political and media spotlight currently shone on the energy suppliers to transfer to the regulator. Having the regulator responsible for setting maximum prices may take some of the heat off energy suppliers, but the risk is that this pressure will transfer to the regulator and could trigger further intervention in the market.

In other words, a price cap will not prevent a further increase in electricity bills. It will not reduce or remove this element of frustration with the energy market. To attempt to use it for that purpose – for example, by not allowing cost increases to be passed through - would at best just defer such price increases and at worst create more problems by distorting the market and discouraging new investment. Increasing energy bills may indeed be a real problem, but a price cap is not the solution.

## 2.2 The pricing of Standard Variable Tariffs

The other main element of concern is associated with the continued large number of customers on Standard Variable Tariffs (SVTs). We deal with four aspects: the existence of SVTs, their price differentials from other tariffs, the extent of these differentials, and the presence of a distortion in the market.

SVTs are not undesirable per se. For customers who prefer not to spend time engaging in the market, they are an entirely appropriate type of tariff. For such customers, they can be preferable to fixed period tariffs that require repeated active engagement every year or so. Members of this BEIS committee, and others, have rightly said that customers should not be forced to engage in the

market. So the problem, if any, is the level of price embodied in the SVT, relative to the prices of other tariffs, rather than the concept of the SVT.

Nor are differentials in tariff prices undesirable per se. We pointed out that SVT tariffs typically try to smooth wholesale prices over time. They can be either higher or lower than fixed tariffs, depending on how wholesale prices are moving.

In a competitive market, suppliers can expect to lose existing customers over time, whether due to natural wastage or to other suppliers luring them away with better offers. To gain new customers, and to retain some existing customers who would otherwise leave, suppliers need to make attractive offers. If they have a large number of existing customers, they may well be able to cut their prices only if they do so for these potentially new or potentially leaving customers, not for all their existing customers. In other words, differential pricing enables suppliers to cut prices to some customers even if they can't cut prices to all.

Such differential pricing is not specific to the retail energy sector, nor to the Big 6 suppliers. The graph that Octopus Energy submitted to the Committee shows that no less than two thirds of the 45 suppliers listed had differentials between their Standard Variable Tariffs and other tariffs. Differential pricing is also common in many competitive markets throughout the whole economy (and internationally). It is not generally a method of exploiting market power, it is generally a method of competing. And prohibiting it is generally against the interests of customers – as was demonstrated when Ofgem introduced its non-discrimination clause in 2009 and the suppliers removed their lower prices rather than their higher prices.

In order to survive and operate economically, most energy suppliers seem to need a combination of less engaged customers on higher tariffs and more engaged customers on lower tariffs. If all their customers were on a single high-priced tariff, they would lose customers. If all their customers were on a single low-price tariff, they would not be able to cover their total costs. In either case, they would eventually go out of business. (Of course, some smaller suppliers may be able to compete with a single tariff, at least for a period of time, if they have some other distinctive feature, such as Green credentials or exceptionally low costs or non-profit objectives, but it is not yet clear that suppliers can achieve scale without a variety of differently priced tariffs.) So in assessing whether a market is competitive, it is necessary to look at the whole range of prices, not only the lowest prices.

Ofgem's *Report* makes a similar point. It finds that both fixed tariffs and SVTs cover their direct costs and make a contribution to suppliers' total costs and profits. But pricing all tariffs at the level of fixed tariffs would not be viable. "We estimate that if SVT prices were reduced so that they provided the same gross profit margin as fixed tariffs, then suppliers would have made a 6% loss ..." (p 31) Fixed tariffs should therefore not be taken as "the competitive level" of prices.

We suggested to the Committee that the retail energy market does seem to be broadly competitive in the sense that the Big 6 suppliers as a group broadly cover their costs without making excess profits. (Some make higher profits and some make losses.) And new entrants continue to challenge, with their market share doubling in the two years since the period studied in the CMA report. The significant differentials between fixed tariffs and SVTs may therefore be an indication of the strength of competition at the moment, rather than a sign of lack of competition.

### **2.3 A distortion in the market**

We suggested in the hearing that an additional factor artificially distorted and increased the price differentials in the market. Smaller suppliers (those with fewer than 250,000 customers) are exempt from certain environmental and social costs (notably the Warm Home Discount WHD and the Energy Company Obligation ECO). Information about the extent of these costs and who pays for them is not at all transparent. But it has been estimated that, in aggregate, exempt small suppliers now have about 7% of the market, or about 1.5 million customers, and that for customers of larger suppliers the costs involved amount to around £42 per year on a domestic dual fuel bill.<sup>2</sup>

Exemption from costs on this scale is significant in enabling the smaller suppliers to undercut the larger suppliers. This in turn forces larger suppliers to increase the differentials between their fixed tariffs and their SVTs if they are simultaneously to compete to avoid losing customers and to cover their total costs. Thus, engaged customers of smaller suppliers avoid their full share of environmental and social costs, while SVT customers of the larger suppliers end up footing the bill. Moreover, the lowest prices in the market give a misleading impression of the competitive prices that are actually sustainable and cover all costs.

In our view, therefore, while the concern about SVTs and price differentials is understandable, it should not lead to the conclusion that the competitive market is not working, or that it does not benefit customers generally. Nor should it lead to interventions like SVT price caps that would reduce competition and make customers worse off in the longer run. The extent of tariff differentials has been exacerbated by an exemption from environmental and social costs that has outlived its original purpose. To help clarify the situation pending the winding down of this exemption, the Committee may wish to invite Ofgem to publish and update a calculation of the value of the exemption, as part of its regular market reporting.

#### **From**

Stephen Littlechild, Director General of Electricity Supply and Head of the Office of Electricity Regulation (Offer) 1989-1998

Stephen Smith, senior executive positions at Ofgem 1999-2002 and 2003–2010 including Managing Director, Markets, 2004-2007 and Executive Board Member, GEMA 2004- 2010

We appeared on behalf of the five former energy regulators, and this note similarly reflects our collective view.

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<sup>2</sup> <https://www.centrica.com/news/levelling-playing-field>