

# The Energy Price Cap: Towards a 'Fairer Market' for UK Consumers? the Economist's view

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UCL Laws Event, London

23 January 2019

# My view differs from that of some CMA economists & others

- Is the domestic retail energy market characterised by weak customer response? No
- Is there customer detriment of £1.4bn/£2bn? No
- Is there unilateral market power? No
- Is weak customer response a more significant problem for PPM customers? No
- Is PPM competition limited by PPM meter constraints? No
- Is there a need for a PPM tariff cap? No
- Is there a need for default tariff cap? No

# Weak customer response?

- CMA: There are substantial gains from switching that go unexploited – average £164 (dual fuel) for Big6 SVT
- This is based on unrealistic assumptions
- If customers can't/don't change tariff type or payment method, average gain is only £65
- Is that worth the risks involved? Is new supplier better?
  - Oct 2017 lowest price from Iresa £790 – then Iresa went bust
  - Next lowest Economy Energy £815 – but also highest SVT £1215
  - In 2018 Economy Energy increased price by £311. Then went bust
  - Outfoxthemarket 4 price increases in 4 mos, Bulb 3 times in 6 mos
- Big variations in quality of service
  - Small suppliers ave 5.5/10 (Citizens Advice) – but range 2.6 to 9.4
- Suggests customer response prudent rather than weak?

# Establishing a reputation

- How does market deal with such risks?
- Firms establish reputations for better prices, good service & financial reliability, & take market share
- 7 Medium energy suppliers seem to have done so
- Is it taking too long in retail energy market?
  - Supermarkets: Aldi & Lidl have taken total 12% market share in about 25 years
  - Energy: 7 Medium suppliers have taken 14% market share in about 10 years
- Retail energy market broadly as competitive as supermarkets?

# Customer detriment

- CMA ‘direct method’ ave £1.4bn (£2bn 2015)
  - About £75 per dual fuel household per year
  - CMA compared actual prices with hypothetical efficient suppliers in steady state – essentially “an idealized perfectly competitive market”. This seems inconsistent with CC/CMA Guidelines saying it will not use such a benchmark
- CMA ‘indirect method’ ave £720m/year
  - Includes ‘inefficient cost’, contrary to usual CC/CMA practice
  - Usual CC/CMA calculation: excess profit ave £303m
  - Relative to return in competitive I&C market: ave £170m
  - £7 per year on ave dual fuel bill of £1200 – minimal
- Detriment an order of magnitude less than claimed
  - 2 Big6 suppliers made losses – doesn’t suggest market power

# Two tier market?

- Do many energy suppliers price discriminate? Yes
  - But this is normal in real competitive markets
- Do lowest prices reflect “competitive level” and higher prices reflect market power? No
  - Firms in all competitive markets vary margins to cover overheads, low margins are not viable on all products
  - Many low prices are only introductory offers
  - Low prices of Small suppliers subsidised (exempt from social & environmental costs over £40/yr)
  - Many low prices not sustainable – some suppliers went bust
  - Other suppliers are not yet making a profit
  - Some suppliers subsidised by city councils (Bristol, Nottingham)
  - Some low price suppliers have low service standards
- Competitive markets have a wide range of prices

# Is PPM sector worse than retail market as a whole?

- CMA imposed PPM tariff cap
  - because “weak customer response is a more significant problem among PPM customers”
  - and because of certain PPM metering constraints
- Situation unclear at time of CMA Report
- But customer response stronger in PPM sector
  - Entrants have now taken 25% of customers in whole market – but they have taken around 33% of customers in PPM sector
  - Largest entrant half size of smallest Big Six supplier - but in PPM sector two entrants each now bigger than five of Big Six
- Metering constraints have not limited competition
  - Smart meters have been means of PPM entry, not barrier

# Tariff caps

- So is there now a need for a PPM tariff cap?
  - No, now apparent that PPM sector arguably more competitive than retail market as a whole
- What was case for default/SVT tariff cap?
  - £2bn harm [£75 per household] is so great & proposed remedies [to increase customer engagement] will take time and are untried & untested
- Fair point about those remedies – but neither they nor cap are needed because £2bn harm not credible
- Because detriment overstated & two-tier market misconceived, both tariff caps have been set *below* the ‘competitive level’ by about £75



# The disadvantages of tariff caps

- “... 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.”  
(CMA p. 656)
- Reductions in competition are already happening
  - Less variety of tariffs
  - PPM and SVT prices clustering at or just below caps
  - PPM switching rate down by 1/3 or 1/2 of previous level

# What to do?

- Not realistic to withdraw tariff caps immediately
- But can ease transition back to competitive market
- By avoiding “cliff edge” situation where ending tariff cap leads to possible £75 increase in tariffs
- Suggestion: phase in £75 increase in PPM tariff cap
  - by gradually increasing Headroom over last three periods of PPM tariff (Oct 2019 to Dec 2020)
- Competition will be seen to increase again
- CMA taking lead will enable Ofgem to similarly transition the default/SVT tariff cap
  - Act allows Ofgem’s calculations to put increasing weight on future consumers and on incentives on suppliers & consumers
- Not easy – but CMA needs to start process a.s.a.p.