



The CMA's assessment of customer detriment in the UK retail energy market

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Stephen Littlechild

Following concerns about rising energy prices, the Office of Gas and Electricity Markets (Ofgem) in 2014 asked the Competition and Markets Authority (CMA) to review the UK energy market. It specified five issues for particular examination, including “weak customer response” – that is, it found that many domestic (residential) customers could change their energy supplier and get a lower price, but did not do so. In its *Final Report* in 2016, the CMA found “an overarching feature of weak customer response” in the domestic market which had an “adverse effect on competition”. It said that this gave market power to the six large former-incumbent suppliers, enabling them to engage in price discrimination against less engaged customers (elsewhere called a “two-tier market” or a “loyalty penalty”) and to make excess profits and/or to operate inefficiently.

The CMA’s “preferred estimate” of customer detriment in the form of higher prices was an average of £1.4 bn per year over 2012-2015, rising to almost £2 bn in 2015 (where £1 = US\$1.33 in June 2016). On average, this detriment represented 9% of the bill of a dual fuel customer. The CMA considered but rejected the remedy of a widespread price cap, and recommended instead that Ofgem should experiment with different ways of promoting greater customer engagement and switching. However, in a note of dissent, one member of the CMA panel recommended in addition a temporary widespread price cap because of the size of the customer detriment and the limited effectiveness to date of measures to promote customer engagement. In July 2018 the Tariff Cap Act required Ofgem to impose such a cap on most domestic energy tariffs.

Several aspects of the CMA report and methodology have been critically appraised by the present author and others. Given the impact that the CMA’s calculation of customer detriment has had on policy, the present paper seeks to better understand and appraise that calculation, in the context of previous investigations by UK competition authorities.

Section 2 looks at how the CMA and its predecessor the Competition Commission (CC) have investigated other markets. These investigations have used two different approaches to calculate customer detriment, one (the ‘direct’ approach) based on a comparison with the prices that it is estimated would have obtained in a competitive market, and the other (the ‘indirect’ approach) based on excess profit. Section 2 finds that the customer detriment is significantly higher in *Energy* than in the other markets. Also, the three most comparable investigations expressed reservations about the price estimates and relied mainly on excess

profit calculations, and did not include estimates of cost inefficiency, in contrast to the Energy investigation. The *Cement* investigation estimated the competitive price to be that of the least efficient plant required to operate, whereas the *Energy* investigation estimated it to be that of the most efficient plant available. Hence, *Energy* used a very different set of assumptions and methods.

Section 3 examines the CMA's preferred so-called 'direct approach', involving the characterisation of a 'well-functioning retail energy market' that it used as a benchmark against which it calculated customer detriment. The paper argues that the CMA's benchmark was a long-run equilibrium concept inconsistent with the CMA's own *Guidelines*, quite different from the method used earlier to calculate detriment in the cement market. This section also presents some calculations and a diagram of costs and market shares to compare with a similar diagram used in *Cement*, to show the contrast in approaches.

Section 4 explores some arguably more realistic assumptions about customer response and the costs and capacities of different suppliers. If the CMA found customer response "weak", what would have been "normal"? Rather than assume that all customers would switch to the lowest cost supplier, a more realistic benchmark would be the result of Ofgem's "collective switch" trials which found that about 25% of less engaged customers were willing to switch supplier when encouraged to do so. And rather than assume that all suppliers could operate at the cost of the lowest cost supplier, more realistic constraints are assumed on the expansion of lower cost suppliers. These more realistic assumptions reduce considerably the size of the customer detriment.

Section 5 briefly examines the CMA's 'indirect approach', which is based on a calculation of excess profit. It shows that adding an estimate of inefficient cost to excess profit, which the CMA did in *Energy* but which previous investigations have not done, greatly increases the size of the detriment.

Section 6 summarises the findings. The exceptionally high detriments of £1.4 bn and £2 bn do not indicate an exceptional lack of competition but rather a significantly different approach by the UK competition authority. The approach taken misrepresents the nature of competition and overstates the extent of market power and customer detriment, and thereby invites inappropriate intervention. It suggests that the CMA could usefully reconsider its stance on the concept of weak customer response. The CMA should not assume that, in a 'well-functioning market', all firms would be as efficient as the lowest cost firm. Previous investigations were right to put more weight on conventional excess profit calculations, without adding in an element for alleged inefficiency, rather than on hypothetical calculations of what a competitive market would have looked like. It also raises the question whether the competition authority and regulatory authorities should be encouraged to work closely together or to challenge each other's thinking.