The CMA Energy Market Investigation: Companies 5-0 CMA?

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The Big 6 energy companies have scored a great victory at the CMA, and against considerable odds. Faced with an adverse finding that they have made excess returns of around £1.7 billion per annum for the period 2012- 2015, rising to £2.5 billion in the last year from the 70% of customers on the Standard Variable Tariff (SVT), they have scored 5 clear goals. At a cumulative total of almost £8 billion excess identified by the CMA, they have done extremely well to avoid any serious damage.

Indeed, they have actually won even greater freedom of manoeuvre. In a period in which fossil fuel prices have fallen sharply, they have held their prices, increased their margins and walked away from the CMA in very good shape. There can be few examples in the history of the CMA and its predecessors of such a comprehensive success in presenting the case for the defence.

Goal 1 has been to persuade the CMA that it is perfectly normal to charge loyal customers more than switchers. As long as the customers have cheaper alternatives, the CMA agrees that it is fine to charge them a premium for their loyalty. Those customers who do not switch are largely to blame. The Big 6 have convinced the CMA that in a normal competitive market, this is what happens, and it is not the job of the CMA to protect them from their laziness, or ignorance. If customers are too stupid to switch, so be it. As long as the options are open, the CMA has concluded that competition authorities should largely keep out.

Goal 2 is to have got the CMA to relax the constraints on the number of tariffs they can offer. The CMA is happy to allow these to multiply and hence for there to be much more choice and complexity. This is a significant de-regulatory victory. The companies have in the process landed a serious blow on Ofgem. In

place of Ofgem's attempt to make the tariffs comparable (for what is an homogenous good), by reducing the number to 4, the CMA will allow a free for all. Now the complexity will be back, it will be much harder to work out what is going on – for Ofgem and for the customers.

Goal 3 is to have convinced the CMA that to the extent there are any problems, they are largely about customer disengagement and switching, and not about market abuse or price discrimination. The CMA seems to think that the switching will become much more extensive, in part because Ofgem will be forced to keep a register of all the customers who have not switched, and pass these on to the industry. The legal difficulties are considerable and for the companies, this victory is all the better, because it will be Ofgem's fault if this fails to work out as planned. There will inevitably be endless arguments and debates about this data and how it is passed on to others.

Goal 4 is that the 4 million pre-payment meter customers who will get some protection are to be charged a penalty tariff to make sure they would in theory be better off switching. Thus the poor and most vulnerable will have to pay a (smaller) excess charge.

Goal 5 relates to smart meters. The CMA has been convinced that these will solve most of the remaining problems and once in place by 2020 even the pre-payment protection can be withdrawn. To the CMA, smart meters are coming to the rescue, and in the process will rescue the companies from the last vestiges of price regulation.

Unsurprisingly, the share prices have risen and with these 5 goals, the Big 6 can relax, and take their time on lowering the STVs. Indeed, as one commentator noted, they could even put the SVT up. No one appears to have the appetite to return to the fray anytime soon, notwithstanding the very good and sensible position of the one dissenting commissioner, Martin Cave.

From the customer perspective, it all looks very different. Bearing in mind that even the pre-payment protection contains an excess returns element, all the customers have gained is that their data will be shared with others. This they may not welcome, especially if they are now subjected to all the marketing that the CMA clearly wants imposed on them. Their goal score is therefore effectively 0.

So how did it all end up such good news for the companies? How did they pull off this remarkable result? And have the companies won too much? What should they do to prevent the scale of their victories coming back to haunt them later? Though the CMA made a real meal of it, and took nearly 2 years, the issues are actually very simple – and fundamental. And, they will not go away.

Different views about competition

The CMA is all about competition. That is the name on the tin. You might therefore think that it understood what competition is. It clearly thinks it does, and in this case it has followed a very clear and Austrian economics script. In Austrian economics, the key idea is that competition thrives when there are lots of excess profits to go after. If there are fat and juicy margins, then this will attract rivals to make better offers to customers. Excess profits are not, on this view, a sign of monopoly and market power, but of a healthy dynamic market.

It follows on this view that prices should not be expected to be closely following costs, and the CMA should not be bothered much is there are excess returns. Indeed, as it has clearly done in this case (and especially for the pre payment customers), it should make sure that the possibility of such excess returns is kept very much alive. This excess is the bait for the entrants and rivals.

But for the Austrians, as for the more conventional neo-classical approach, there is a paradox here. The more intense the competition, the more these excesses get eaten away. As prices are driven back to reflect costs and a normal return, the intensity of competition drops away. As Hayek famously noted, the trouble with

perfect competition is that it is dead – the more competitive a market, the less competition.

This tension is typically finessed, for fear of letting go completely. The CMA bought most of the above argument, but couldn't quite carry it through. The sheer scale of the excess charges stretched the credibility of a pure laissez faire answer. The CMA had explicitly endorsed excess returns in its earlier general penalty tariff proposals and now in its more limited pre payment penalty tariff, but presumably for fear of telling customers too explicitly that it is in their interest to pay too much, tried to hold a temporary line. As a result the CMA is under attack from both sides. The Austrians (and they have been very vocal in their criticisms of Ofgem and any proposals for regulating margins) want *all* constraints removed. They do not even think pre payment customers should be protected. The contrary view is that argued by Martin Cave that all the SVT customers need more protection. The CMA has nowhere to hide in its attempt at trying to agree with both, and satisfying neither.

The unavoidable facts haunt the CMA. It did find excess returns – significant excess returns. It did find that these excess returns *have been going up* whilst the CMA has been inquiring, whilst costs have been going down, and even when switching is going up. In effect, Ed Miliband's price freeze has been implemented, to the great benefit of the companies. And 70% of the customers – an enormous amount in any markets – are missing out. But switching will, the CMA believes, solve the problems, especially when smart meters come to the rescue. In this great switching world, the companies will not rebalance tariffs, or exploit any market power, for the fear of instantly losing customers as they permanently surf the web for better deals.

The great switching enthusiasm

Why exactly would switching work? Why indeed is it such a good idea? The CMA does not seem to have even asked these questions. Yet if – and for the CMA it is a big if – competition is a *means* and not an *end*, it is pertinent to ask just how does

the means of switching produce the end of cost-related prices which are fair and reasonable.

Lets start with the end: the provision of fair, reasonably priced energy to consumers. The fair and reasonable price should comprise: the costs of the ultimate fuel inputs (things like gas and coal and nuclear fuels – wind and solar inputs are effectively free); the costs of generating the electricity; the costs of transmission, the costs of distribution; the levies; the FiTs; the capacity contracts; and then finally the costs of billing and metering the customers and dealing with their inquiries.

The main fact about these costs is that for a stand-alone supplier *almost all of these are fixed and exogenous to them.* They do not control any of these, except the customer interface – the billing and metering and related customer services. They may claim they hedge the wholesale costs, but this can only be a short term impact, and their record on this varies from mixed to bad. Most customers would have been much better off if their suppliers had not hedged and had just passed though the actual wholesale prices. There is not much room for differentiation, or innovation. Electricity is just electricity – even more homogeneous than petrol. It about the most boring consumer product one can think of.

For the things that the suppliers do control, several of them have at best had mixed performances. There have been extensive and repeated failures in billing and customer services, and the industry has repeatedly been fined for these failures, with RWE/npower standing out amongst the worst customer service deliverer not just in the electricity and gas supply businesses but across the whole economy. The result has been, as one CEO has honestly admitted, a significant loss of trust.

If supply competition is about so little of the supply chain, it follow that the main sources of the sharp divergence between prices and costs that have led to the excess returns identified by the CMA actually have very little to do with the costs that the supply businesses actually control. *The suppliers have been increasing*

their margins partially on the basis of changes in exogenous costs to suppliers. The excess returns have had very little to do with the “dynamic competition”, “innovation” and “differentiation” so beloved of the Austrians. They have been about the boring old stuff – electricity – and its wholesale price. The great collapse of the global super-cycle has so far largely passed British electricity customers by.

In the bits of supply costs actually within the control of the companies and their management, and on which they are rightly entitled to earn a good return, the next point is that there are really big economies of scale. Handling customers is all about IT systems and the associated databases. These systems do not come in little incremental bits: they come in *systems*. It is very much more efficient to handle millions of customers than the odd 100,000. Indeed so great are these economies of scale that entry from competitors has had to be rigged. Below a certain number of customers, the entrants do not have to charge their customers some of the fixed levies. This is the deliberate management of levies (taxes) to engineer advantages to one type of player.

The questions that arise from all this are several. First, why is competition supposed to work, except in niches, if there is no convincing evidence that the economies of scale are going to go away, and hence the entrants will always be on a life-support system, threatened by retaliation from the incumbents on the basis of the lower costs from the economies of scale? As the incumbents are able to offer multiple tariffs, the entrants will be all the more vulnerable to targeted responses. The CMA offers no convincing answer. It is almost an article of faith that competition always works.

Second, it should be expected that indexed wholesale price pass throughs would have been offered to customers, since this is in the nature of exogenous costs. Why have these sorts of tariffs not been offered, and why have incumbents been able to pass through their hedged (typically higher) costs? The CMA provides no answer.

Third, and this is the cumulative question, why are the margins so high, given the limited costs, which the suppliers' control? Why exactly does anyone need to earn 5% or even 9-10% on domestic electricity and gas? How could it really cost this much to do the billing and metering and customer services? The CMA has no answer.

Finally, as more and more of the costs are fixed – as more and more generation is zero marginal costs – why will switching make so much difference in the future if it has not in the past when the wholesale market was more important? The CMA does not even recognise this possibility.

Smart meters to the rescue?

The very limited price controls to be put in place just for pre-payment meters are intended as temporary. The CMA thinks that smart meters are a panacea: they will solve most of the outstanding switching problems, or least go so far as to make any regulation redundant.

This is quite a breath-taking assumption. In just 4 years (or probably 3 or less, given how long it will take to implement to data handling by Ofgem), all the troubles in this market will be a matter for historians and academics, and customers will all be getting a good deal through their smart meters, even if they will continue to pay some excess in the meantime. Really? Is the CMA serious? If this was really the case, there would be a very rapid decay of the margins between now and then – in 2016, 2017, 2018 and 2019 – and a sharp fall in profits. The excess returns would be extinguished – and the industry would lose several billion (in the CMA's view about £2.5 billion per annum on the current numbers). Dividends presumably should be cut. Nobody seems to believe this – and yet that is pretty much exactly what is implied by the CMA's arguments. The share price reactions to the CMA tell a rather different story.

Very little of this is happening for a very good reason. Smart meters are a good idea, but they are not the existential threat to the incumbents the CMA

apparently assumes. Ask yourself the following questions: just what exactly is the smart meter supposed to enable *which will actually reduce profit margins*? How exactly are smart meters going to work in a world with much more fixed costs, and more zero marginal costs?

To repeat, smart meters are a good idea, but the way they will change the market is poorly understood. When they were trumpeted as regime changing by ministers in the past, some of them really did think that the result would be that customers would be able to look at the meter, see real time prices and decide when to turn the cooker and the dishwasher on.

They also assumed that they would be jumping up and down watching big variations in ever-rising prices – because they "knew" that the underlying fossil fuel prices would be going up, as "peak oil" would begin to limit supplies.

Almost all of this turns out to be nonsense. The main impact of smart meters is passive not active for the customer – it is all about the management of the *system*, and to a limited extent the smart interactions of appliances. The smart meter is really just a bit of the broadband hub, around which a host of digital and data related services will be provided.

Furthermore, the importance of price variations is likely to decline for lots of reasons. There is much more zero marginal cost generation on its way, a host of small flexible generation coming, and much more storage. The result is that prices are getting *less* volatile and *less* peaky, not more so, and hence variations on household demands may not be quite as important as the CMA must be assuming. The wholesale market is getting less important relative to the fixed price capacity and FiTs contracts – which are all system costs passed through to final customers. This all means there is less and less to play for with the smart meters. The variable wholesale costs are less and less important parts of the final price of electricity. The CMA seems unaware of these fundamental structural adjustments.

This all fits into a wider picture. In the coming digital economy, and in an economy that must as a result be largely electric, security and stability of supply will become more and more important. Consumers and industry and the public services will all be relying on very secure and continuous broadband, and they will want ample electricity to power these systems that will dominate the economy. In this ever more USO world, broadband and electricity will need serious cushions on the supply side and, spread over so much more of the economy, and the costs of these extra capacity margins should be pretty small.

The CMA should have worked through these fundamentals given they think smart meters are going to solve so many of the problems. The CMA's case largely hangs on the above analysis being wrong. After two years of study, it should have seen the convergence of smart meters and broadband and it should have understood the impact of electricity becoming more like broadband – a capacity and less an energy market. In a pure capacity world, the point of the smart meter is to manage the system as a whole. It is not for customers to jump up and down all evening to check the meter as so many ministers seemed to have believed – or indeed to keep tracking all the deals online to get the latest tariff to switch to. They have better things to do.

What will probably happen next

The CMA has done a very poor job (with the exception of Martin Cave). This will not go down as one of its finest moments. It has had 2 years to come up with a sustainable framework for a market that is widely held in disrepute. What it has come up with is a compromise that will not remedy the detriments it clearly identifies – as Cave rightly notes.

If Cave is right, the results are very predictable. The companies have won a great short-term victory. They have played their cards brilliantly, and run rings round the CMA. Their profits and margins are pretty secure, even at the current levels. They can carry on charging more to the SVT customers for several years to come. They have most of the aces now in their hands: the economies of scale; the ability

to proliferate tariffs to create mind-boggling complexity all over again; and they can blame Ofgem for the horrors of mass marketing, cold calling and the plague of marketers that will now hound those who choose not to switch. And if it does not all work, then the CMA has given them a great let out: the CMA effectively blames the customers for being too lazy, stupid or ignorant to switch.

But the companies, whilst getting a short-term boost, and being able to maintain and indeed probably grow their dividends, should pause and reflect. Winning too well is rarely sustainable. For the CEOs who think that customer trust and their reputations matters, this may not have a happy ending. If prices are not related to costs, and if they remain like this, and if the bulk of the customers refuse to switch (or possibly even end up worse off switching or are victims of miss-selling), then it might all unravel.

To date, contrary to the CMA, customers have had good reasons to sit on their hands. The suppliers are not trusted for good reason: they have miss-sold, there have been episodes of sustained appalling service, and many switchers have in the past ended up worse off. And why exactly should it be customers that have to switch? Isn't it reasonable to regard electricity as a USO service, and to be entitled to supplies that are not only secure but come with a reasonable margin? Petrol prices have fallen with the oil price falls. Why haven't electricity prices fallen for all, as wholesale prices have also fallen back sharply? Why exactly is the means more important than the end? Why can't a loyal customer expect to be charged a reasonable rather than an excess price? These questions are not going to go away.

For Amber Rudd and the Chancellor, the CMA report is not the obvious convenient get-out-of-jail card that it might seem. What it means is that the discontent will probably continue to simmer. The CMA inquiry was a way of kick Ed Miliband's very popular attacks on the Big 6 into touch. It was very successful in this limited objective. But what it has not achieved is what the government must most want: that electricity prices will not be on the political, public and

media agendas in 2019 and 2020, at the next general election. They will probably live to regret endorsing such a flawed report.

That in turn will have repercussions for the companies. Their shareholders value the dividends and they want stability. The CMA has given them virtually everything they could have dreamt of at the start of this process. But it will probably prove to be too much.

Is there an alternative even now?

What can the government and the companies do now that the CMA has committed to this path? There are three possibilities even at this late date.

The first option is to buy Martin Cave's dissenting opinion, and to follow through on his recommendation – the extension of protection to all SVT customers. In an earlier paper *Penalty tariffs, open-ended regulation and embedding overcharging – a critique of the CMA provisional findings and remedies* (EFN Paper no.12, 20th July 2015) I set out how a default tariff might work, based upon the passing through of the wholesale price (an index) and all the other fixed pass throughs, leaving the companies to choose a margin on top to reflect their controllable costs. This would be unregulated, but published. It would be simple, effective, fair and allow the companies to focus on the bit they can and should compete on – the services they actually provide and manage. It is not however the penalty tariff that the CMA had earlier recommended and which explicitly allows for excess returns. Only the structure of the tariff is regulated as a default option for customers. Thus it covers the same domain of Cave, but the detail needs to be modified to leave margins to be freely determined.

The second option is more radical, and rather than relying on Cave's dissenting opinion, rejects the CMA's approach outright. It would be brave for ministers, and it would require quite a lot of humble pie. Yet this is what may happen in any event – but after a lot of grief, and as part of an angry General Election argument

about the very issues that Miliband raised. There will be calls for much more radical interventions later, and the threat will hang over the industry.

The third option is for the industry to take a lead and to be thoughtful and reflective about its victory. The Big 6 could implement the default tariff suggested above themselves. They will have in any event to defend what to do about their SVT customers, many of which will effectively be theirs for quite a while. They could offer a fair and reasonable default tariff to those who do not switch. The pass through plus margin tariff could be what they offer.

It would probably not make as much profits for them in the short term, but it would offer two big prizes that they should at least consider. It would keep their loyal customers, and be seen to reward their loyalty. Their revenues would be more stable, and hence their dividends too. But much more important it would to a great extend and enhance what might be called their “social licence to operate”. Trust might even return, and importantly they would probably avoid being a political football at the next election. They could make a virtue of their victory at the CMA and act magnanimously.

Of these options the government should, in its own interests, follow Cave. Whether or not the government does this (and it probably won’t), the companies should in any event seriously consider implementing the default tariff for SVT customers as outlined above.

Finally, there are the wider implications for the CMA. A major inquiry like this is studied not just by the specific industry, but also more generally for clues as to the challenges and risks of future CMA inquiries. The CMA should undertake a serious post mortem.