

## **Penalty tariffs, open-ended regulation and embedding overcharging – a critique of the CMA provisional findings and remedies**

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**20<sup>th</sup> July 2015**

1. When, in the face of the sustained attacks from Labour's Ed Miliband and Caroline Flint, OFGEM referred the electricity industry to the Competition and Markets Authority (CMA), many hoped the result would settle the controversies once and for all, restoring trust and putting the industry on firmer foundations. The CMA has now spent a year investigating the electricity market, and come up with its preliminary findings, and proposed remedies. Unfortunately these fail to convince on most fronts: the result is a messy compromise, which will most likely continue to dog the industry for many years to come. This paper explains why.
2. At the heart of this energy market investigation is a deep and fundamental tension between an outright competitive solution, and a regulated solution. The CMA tries to fudge the answer: it wants "temporary" regulation for a problem which it acknowledges will go on for the "foreseeable future" – that, for over 70% of customers, switching does not excite them and they are consequentially disengaged with the market. There are many problems with the CMA's temporary regulation, but one should be recognised explicitly: temporary regulation tends to become permanent.
3. The CMA's temporary regulation is designed to promote switching, which it sees as the eventual answer – even if after 17 years it has not worked for the bulk of the customers. To try to both promote competition and protect non-switchers, the CMA comes up with a proposal which is going to be very hard to make stick: it wants customers who do not switch to pay "headroom" to suppliers, embedding excess profits into the tariff. This "safeguarding" tariff is designed to encourage customers to switch. Such a tariff is better described as a *penalty tariff*, punishing those who do

not switch - notably, on the CMA's own evidence, the poorer, less educated and otherwise disadvantaged customers. In other words, the Big 6 can go on overcharging the non-switchers – just not by as much.

4. Just how the CMA ended up recommending overcharging and excess profits be embedded in its proposed regulation is a case study in the failure to be clear about the objectives, regarding competition as an end in itself and not merely a means, and failing to follow through on the analysis. Fortunately, there are better ways of addressing these issues, and these will be set out below. It is not for want of alternatives that the CMA ends up with this messy compromise.
5. The structure of this paper is as follows. The starting point is the validity or otherwise of the central allegations advanced by Miliband and Flint – whether the companies have been overcharging; whether prices are related to costs; and, if they have overcharged, by how much. In the CMA's terminology: do the companies have unilateral market power? Are there excess returns? Next comes the analysis of the wholesale market and vertical integration – both of which are given clean bills of health by the CMA, despite some obvious gaps in the empirical analysis. This then leads to the substantive part of the CMA's findings, its analysis of retail markets and the problem of the switchers and the proposed penalty tariff. The paper ends by setting out a straightforward and practical resolution of the apparent trade-off between promoting competition and protecting the bulk of the customers, and a way of providing stability and restoring trust to this vital industry – and one which the CMA fails to properly consider. Along the way, comment will also be made into the CMA's foray into trying to make competition the end and not just the means by changing the law on OFGEM's statutory duties. The issues in relation to feed-in-tariffs, the capacity market and transmissions losses are not addressed here.

### **The overall findings – largely agreeing with Miliband and Flint**

6. At the general level, the CMA agrees with Ed Miliband's analysis presented in the run up to the General Election. The CMA's provisional finding is that "*the Six Large Energy Firms enjoy a position of unilateral market power over their inactive customer base and have the ability to exploit such a position through pricing their SVTs materially above a level that can be justified by cost differences from their non-standard tariffs*".
7. The CMA provisionally finds the Big 6 have used this power: they have overcharged these customers by over £1 billion.
8. A key remedy that the CMA comes up is a "safeguard tariff" to protect customers whilst competition comes along. The CMA "*will tend to favour remedies that can be expected to show results within a relatively short time frame*".
9. So far, so Miliband and Flint. Recall that they proposed a temporary price cap whilst the market was reformed to increase competition.
10. The key difference between the CMA position and Miliband and Flint position lies in the identification of the source of the problem: Miliband and Flint advocated reform of the wholesale market and breaking up the vertical integration model, whereas the CMA gives both a clean bill of health. The CMA focuses almost exclusively on the problem of switching and the Standard Variable Tariff (SVT) in respect of competition.

### **Wholesale and vertical integration**

11. The wholesale market changed significantly when the Pool was abolished at the end of the 1990s, and the "anything-goes" NETA (and then BETTA) structures were put in place. The Pool was *by definition* liquid and transparent: power had to be sold into the Pool and anyone could buy in the Pool at the same prices. Hence vertical integration was not exploitable, and it was only after the Pool was abolished that vertical integration became the model of choice. Indeed, this is exactly what the Competition Commission found when it investigated the proposed mergers proposed by National Power and PowerGen for regional electricity companies in the mid 1990s. Bilateral contracting favoured the

incumbents who could physically hedge and sell to themselves, and unsurprisingly the independent generators cried foul.

12. The reason why the CMA is so relaxed about the wholesale market and vertical integration is that it broadly accepts that OFGEM's reforms to NETA have rendered it much closer to the Pool than originally intended under NETA. Indeed the CMA effectively concludes that there are few if any advantages left to vertical integration. The CMA position and that of Miliband and Flint are therefore fairly close: it is just that the CMA (and OFGEM) thinks that the formal step back to the Pool is not needed.
13. For reasons other than those advanced by the CMA, there is some merit in this argument – *in the future*. It is not so much the properties of the wholesale market that give rise to the weakening of the advantages to the companies of vertical integration, but rather the gradual move away from the wholesale market towards FiTs and capacity contracts. These fixed price contracts are open for all to bid for, and it is not obvious that vertical integrated players have any advantages in these auctions and contract awards. As more and more zero marginal cost generation is brought onto the system, this shift will continue. Entry for almost all new generation will be fixed contract driven.
14. The interesting bit about the wholesale market that is missing from the CMA Findings paper is any reference at all to the analysis of the relationship between primary fuel input costs, and wholesale prices – and indeed retail prices too. In a context in which the CMA's investigations have coincided with the end of the commodity super-cycle, and the collapse of oil prices, the sharp falls in gas prices, and behind these the somewhat earlier halving of coal prices, it might have been expected that the CMA would ask a simple and obvious question: have wholesale prices reflected these input price falls, and if so how quickly and completely? Only if this question is asked – and answered – can its extremely relaxed view about the wholesale market be judged. It is not enough to point to entry conditions - and it is worth noting that there has been very little entry except that backed by fixed price contracts. The wholesale market no longer functions as the basis of merchant entry, if it ever did.

15. Failure to take proper account of the live experiment in falling fossil fuel prices which has been the backdrop to this investigation is a serious omission. But of equal concern is the failure to look at profits in relation to the business cycle and the impact of the great economic crisis which kicked in after 2007. In a capital-intensive industry with long lead times, a unanticipated large reduction in demand should cause large scale excess capacity and therefore losses. That is what has happened to other industries with similar economic characteristics. In the case of electricity, capacity margins tightened rather than rapidly expanded as they would have done in severe recessionary circumstances. Over the investment cycle for generation assets (around five to ten years) GDP turned out to be more than 20% below the path it could reasonably have been expected to prior to 2007. Yet this is largely neglected by the CMA. It is hard to see how profitability can be judged exogenously to demand shocks of this magnitude.

### **Retail**

16. Having rather simplistically dismissed concerns about the wholesale market and vertical integration, the CMA turns its attention to the retail market. As noted above, its provisional findings here are remarkable. The CMA is unambiguous: there is unilateral market power and it has been exploited. It then calculates how big the exploitation has been.

17. Its calculation of the extent of the exploitation is however highly questionable. It relies on the rate of return on capital employed – ROCE. Yet retail is a *service* business: it has few assets and, apart from “working capital”, not much else by way of capital. As the CMA itself states, retail energy suppliers “*do not own or operate any physical assets required for the delivery of gas or electricity to their customers’ homes*”. The CMA lists the services: “*energy procurement; securing network access; sales and marketing; metering; billing and customer service; the delivery, on behalf of DECC, of obligations relating to environmental and social policy objectives; and, optionally, the provisions of a range of bundled products and services*”.

18. Why would anything think that the best way to answer the question – are the Big 6 making excess returns – is to look at the return on the capital they employ, when they do not need very much at all? Yet the headline numbers the CMA comes up with – and which featured very prominently in press and media interviews – is based upon ROCE – and a comparison between the 28% ROCE the CMA estimates and the 10% cost of capital it thinks is reasonable. (Just why retail should earn 10% is not properly explained). Whatever the correct total number is, it is not the one the CMA relies upon. What matters is the margin on sales – as indeed the CMA then goes on to partially recognise. Competition is about the efficient delivery of the services listed above, and the gross margin on the services is the return on these activities, assuming the wholesale price is competitive, and the network and DECC costs are exogenous, and all are passed through at cost. This gross margin the CMA finds to be around 17% of the retail cost for electricity and 19% of the cost for gas. What is not explained is what a reasonable margin would actually be. Why do the companies need to earn margins of 17% and 19% for the activities listed above? Does the regulated Northern Ireland supplier earn these sorts of margins? We will come back to this below in seeking out a suitable default tariff remedy.
19. The CMA is on firmer ground in comparing the SVTs to the other tariffs, which are available to switchers. The CMA finds that the SVTs are not related to cost, and they are in significant excess of the switcher tariffs on offer. Worse still – and not properly documented in the CMA's Findings - is the fact that the SVTs are not related to wholesale prices or primary fuel input costs. Indeed, nowhere in the Findings is this relationship adequately reported. In simple terms, whilst fuel input costs have been tumbling, and whilst wholesale prices have been falling during the time of the CMA investigations as the commodity super cycle came to a dramatic end, there has been no fall in the SVT. In fact, over the last three years the CMA point out that they have gone up – a lot. It would be an extraordinary claim to make that this lack of correlation was compatible with a competitive market.

20. One of CEOs of the Big 6, Paul Masera, claimed in 2014 that the reason why the SVT had not been reduced following the big falls in fuel input and wholesale prices was because of the threat of a temporary price cap, in the event of a Labour victory in the General Election. Such conduct would not have been possible in a competitive market. Imagine an oil company not lowering petrol prices because it might have to lower them in the future. Competitors would reflect the falls in oil costs and take market share. The point about the SVT is that the customers do not switch to alternative suppliers, and the companies can rely on this for most of their SVT customers. They do not have to pass through falls in costs.
21. Wholesale prices are only about half the total cost of electricity, and hence it is theoretically possible that the increases in the levies and network costs could have been exactly offset the falls in fuel input costs and wholesale prices. The fact is that they have not, and by a large margin.
22. It can therefore be concluded that the CMA is right in identifying unilateral market power in respect of the non-switchers, and that the prices charged are not related to costs. SVT customers have been charged more. If the non-SVT tariffs reflect costs, then these SVT customers have been overcharged. If the non-STV tariffs are below costs, then the STV customers are cross-subsidising the non-STV customers.

### **Switchers**

23. Being a competition body, and with this set of Findings in mind, the CMA has unsurprisingly looked for competition-based remedies. It faced a profound problem: it appears that the bulk of customers could save quite a lot of money by switching, and they do not. Why? Are they stupid? Or is something else going on?
24. The CMA considers the barriers to switching. These turn out to be: metering; interventions by OFGEM, including the prohibition of regional price discrimination, and RMR 4 tariff approach; and bizarrely, *“the fact that there is not quality differentiation of gas and electricity may reduce consumers’ enthusiasm for, and interest in, engaging in the domestic retail*

*energy markets, leading to customer inertia*". How? Why? Surely the opposite would be the case? Indeed, if the CMA takes the view that the more homogenous the product, the less interest in seeking competitive prices, then this would have radical implications for a host of other markets. It is normally argued that the more homogenous a product (and the less product differentiation) the more intense the competition. In many markets, product differentiation has been a tool used by companies to reduce competition, and competition authorities have pushed for standardisation where the products are in fact homogenous. This applies to retail petrol for example – but there are lots of other examples.

25. The question that the CMA never addresses is whether this will ever be a fully competitive market with lots of people switching regularly. In addition, the CMA never considers whether this would necessarily be a desirable outcome. It just assumes it would.
26. It is only if we are on route to a fully switching market that remedies such as the "safeguarding tariff" will be temporary. Yet the evidence is challenging. In 17 years, the CMA finds in its survey that 70% of customers are not really engaged in this market, and that after 2003 (until the political battles and media headlines in the run up to the General Election) switching went down. During this period, the main suppliers moved from targeting competition on the SVT to the non-SVT domain. Now the suppliers do not offer alternative SVTs.
27. Why, if switching has not caught on for the bulk of the customers after over almost 2 decades since liberalisation, should the CMA believe it is imminent? Or at least sufficiently imminent to make its safeguarding tariff temporary? And that switching is going to work?
28. The CMA's explanation of the reasons for inertia and disengagement are far from convincing. Smart meters will make a difference, but not necessarily in the ways the CMA thinks. Smart meters might give a more accurate reading more frequently, but it does not solve the fundamental problem that now there are already apparently significant gains to be made and customers do not take them up. There are apparently £20 notes lying in the street and either people are too stupid to pick them up, or



perhaps – something the CMA never contemplates – they are not really there, once the full costs of switching has been taken into account.

29. The CMA's approach is very similar to the related issue of why customers do not take up apparently very high net present values from investing in energy efficiency measures. Again there are apparently £20 notes lying in the road. And again, it does not occur to the policy makers and regulators that they may not actually be there. The abject failure of the Green Deal to live up to the ludicrous hype with which it was launched by the then Secretary of State, Chris Huhne, is a salutary case in point.
30. It is important to recognise (and the CMA does not properly address this) that there are costs as well as benefits to switching, just as there are costs as well as benefits to going through the process of investing in energy efficiency. Switching also has considerable system and company costs. The CMA provides no estimate. Unless switching is an end in itself, then this is a serious lacuna in the CMA Findings. All customers pay the "tax" that switching costs impose – and it may be one reason why the gross margins are 17% plus.
31. At the customers' end, there are costs too. For many in the non-switching majority identified by the CMA, switching is far from straightforward. There is no single price, despite the CMA's claim that this is a market that is all about price, and little else. On the contrary, the companies produced a large number of different tariffs until OFGEM stepped in and reduced them to just four.
32. The CMA attacks OFGEM for its tariff simplification. Indeed it thinks it has exacerbated the switchers' difficulties. Curiously, having lambasted OFGEM for its simplification in RMR, the CMA then proposes its own simplifications. It proposes a single replacement for the SVT, and that OFGEM should run a price comparison service on behalf of customers. Whilst there are arguments in favour of both these interventions (more on them below) they are at odds with the attack on OFGEM.
33. Compare the electricity market with retail petrol. The two (following the CMA's argument) are both price driven, since they are homogenous products (though there is some differentiation in the petrol case – with

diesel, lead free and so on). Do petrol stations offer tens of different prices for the same product? Do they offer lots of different price periods and discounts?

34. If the CMA really believes that this is a price-based market for an homogenous product, then it should presumably recommend a single tariff for each company.
35. The argument for lots of different tariffs is that companies might then “innovate” in the services they provide. There is a lot to be said for this, but not by the CMA. It emphatically says that there is no quality differentiation. So quite why there is a problem as the CMA claim that *“some of the RMR measures restrict the behaviours of suppliers and constrain the choices of consumers in a way that may have distorted competition and reduced consumer welfare”* is far from obvious. Surely the whole point of RMR was to restrict the behaviour of suppliers? Surely OFGEM took the view that the proliferation of tariffs was distorting competition? Surely this was one step alongside intervening on doorstep selling and other customer service failures? This is after all an industry in which some of the companies have very poor customer service performance, and where significant fines have been imposed.
36. Why else might customers fail to engage? For many, it is probably a combination of: a desire not to spend time on doing so; a lack of trust in the offers being made; and a basic inability to make the comparisons.
37. The CMA fails to take account of the cost of time. Why would customers want to spend their evenings comparing alternative electricity and gas supplies, when they have many other pressures on their time? Rational customers live in time-pressured households. They make lots of “mistakes” because of these pressures. They have other things to do, and other priorities.
38. The CMA says that switching is “easy”. But rational customers factor in the possibility that it might turn into a “nightmare”. It is, for example, claimed that it is easy to switch bank accounts. But people do not, and for good reason. The direct debits and standing order switches rely on the suppliers getting it right, including on all the systems from which the

services are provided. Experience tells people it is far from straightforward. Most importantly, the costs of “complications” if it goes wrong are likely to involve very considerable hassle. The failure to address these costs and the risks of “nightmares” is wholly neglected by the CMA. But why in an industry where there are so many customer service failures would any rational customers expect switching to magically work without hassle? (There is a similar mistake made in respect of energy efficiency). The idea that it is necessarily desirable to have consumers sitting at home in the evenings comparing bank accounts, electricity and gas deals alongside all the other “deals” they are offered – and perhaps water deals as well – is not one which necessarily appeals. There may just not be enough hours in the day, and failure to engage might be an entirely sensible and rational strategy when thought of in this wider context – one that the CMA fails to consider. Energy is just one of a multiple of household services.

39. The second and related problem is trust. This was indeed a main reason for the reference by OFGEM of the industry to the CMA, and it was a major hope of those companies that welcomed the CMA investigation that it would clear up the lack of trust by demonstrating that the market is working and the companies were not guilty as charged by Miliband and Flint.
40. If restoring trust is a necessary condition for getting switching going, then the CMA has spectacularly not solved this one. Encouraging the media to concentrate on headlines about £1 billion plus overcharging will have reinforced customers’ perceptions that the companies cannot be trusted, and this in turn will make them even more reluctant to trust competing offers from them. The facts are of course the facts. But trust – an essential ingredient to stability – has not been increased by the CMA. The conclusion that follows is that there should not be undue optimism about an upsurge in switching as a result of this investigation.
41. Finally, and perhaps most important of all, is that in order to engage in this market, and despite the claim by the CMA that all that matters is price, the challenge of making informed comparisons is considerable. The

CMA's evidence suggests that non-switchers are more likely to be poor, uneducated and elderly. There is no analysis by the CMA as to how many customers are illiterate, how many cannot handle the internet, and find percentages very hard to comprehend. This matters not just for competition, but also for wider social reasons.

42. The CMA proposes to solve these customer problems – costs, trust and ignorance - by getting OFGEM to do the job for them – to run the price comparison exercise. This is a major step, and it will have an unintended consequence. Given the statutory duty of OFGEM is to protect customers, it will be expected to ensure that the tariffs it publishes do in fact protect customers. If it publishes tariffs which reflect the exploitation of unilateral market power, then it will be open to challenge that it has not fulfilled its primary duty. Therefore it will be drawn into investigating these tariffs and adjudicating upon them. Imagine the challenges that the select committees and the wider media will mount. This is an implicit route to much wider regulation. Whether this is a good or bad thing is a serious question, but at least the CMA should have thought through the implications of giving this role to OFGEM.
43. But its not just the comparisons that matter and the inability of some more vulnerable groups to cope with them. It is also that the CMA explicitly recommends that non-switchers should be penalised for being non-switchers: they must pay a penalty “headroom” to encourage them not to be so ignorant and lazy. We consider this in the next section.
44. It remains a very open question as to whether large scale switching will ever work. There is no convincing evidence provided by the CMA that it will. Yet the CMA's remedies rely on the assumption that it will – and soon. Non-switching is a temporary problem which the CMA assumes will go away. It is a serious error on the part of the CMA not to challenge its own prejudice on this fundamental assumption. Instead of just assuming that the CMA should “*provide the framework for effective competition*” it should also explain why it is reasonable to expect it to work for most if not all customers.

## The CMA's penalty tariff

45. The CMA cannot avoid the fact that 70% of customers are disengaged with the market. The CMA asserts that they have been exploited through the exercise of unilateral market power, and that the prices these SVT customers are paying are not related to costs.
46. Its solution is to *“provide transitional protection against high tariffs”*. It will be some transition, since the CMA state *“there may remain a significant number of disengaged customers for the foreseeable future”*. Presumably the “transitional” protection is “for the foreseeable future”. Given too that the CMA tends *“to favour remedies that can be expected to show results within a relatively short time frame”* using the word “transitional” to apply to its “safeguarding” tariff is misleading. In the “foreseeable future” on the CMA’s analysis the non-switchers will require protection given the Findings on unilateral market power and overcharging unrelated to costs.
47. The dilemma for the CMA is that if it sets this tariff at the competitive level – if it is based upon costs plus a fair margin, then it will kill competition. Why bother to waste all the time and effort, and take the risk that companies cannot be trusted, and might take the customer for a ride, when all these costs and efforts can be saved by sticking with the cost-related (and therefore fair) tariff? This is the great paradox of competition: as Austrian economists argue, excess profits are needed as an incentive for companies to compete for customers. It is the possibility of abnormally high profits that motivates entrepreneurs.
48. The CMA tries to fudge this by arguing that the tariff should not be related to costs, but rather include “headroom”. This is an excess charge above costs and normal profits. It is not a “safeguarding tariff”: it is a *penalty tariff* that non-switchers should be forced to pay. As the CMA states, its safeguarding remedy *“does not aim to set prices at the competitive level, at which level, an efficient firm cannot be expected to earn excess profits”*

49. But why should non-switchers be penalised, and especially if they are poorer, less educated, older and otherwise disadvantaged? Unless competition is an end in itself, rather than a means, there has to be something else they will get as a benefit to outweigh the penalty they are forced to pay. The trouble is that the obvious answer – innovation – is not open to the CMA, because they argue it is all about the price for an homogenous product.

50. The result is very unattractive, but it is the consequence of the CMA's analysis and proposed remedies. In the CMA's world:

- The companies have unilateral power over non-switchers
- Lots of non-switchers are likely to be around for the foreseeable future
- These customers are being overcharged and have prices unrelated to costs

Therefore:

- Non-switchers should pay a headroom penalty to companies.

### **A better way forward**

51. There is fortunately a way out of this mess – and the unpalatable conclusions that emerge. A better way to think of the problem is to concentrate competition on those areas that companies can compete about, and separate out these areas for the exogenous ones where they cannot.

52. There are three main elements of the costs faced by suppliers, which are exogenous, and in a competitive market would be straightforwardly passed through to customers. These are:

- **Wholesale costs.** The CMA argues that vertical integration does not benefit incumbents against entrants, and that the wholesale market is competitive. If these claims are correct (and note some doubts expressed above) then they are exogenous to suppliers.

- **Policy costs and levies**, including green charges, and capacity and FiT contracts. Suppliers have to pass these on: there is nothing they can do about them.
- **Transmission and distribution network costs**. Again these are outside the control of suppliers.

53. Suppliers then have endogenous costs – doing all the things listed above and quoted from the CMA’s Findings paper. This is what the margin is for.

54. As also noted above, competition between the main suppliers was originally targeted on the SVT customers. Initially, rather than encourage customers to switch from the SVT tariffs, companies offered competing SVTs. If the product is genuinely homogenous as the CMA claims, if competition is about price, then competition should be about offering the best price, on the basis of the efficiency with which the supplier can manage its own endogenous costs.

55. This is the rationale for the default tariff that I have proposed. It is not to be confused with a price control for all domestic and microbusiness retail energy tariffs, and in particular it does not require a RAB-type calculation. (Indeed RABs would be inappropriate even if this route was pursued – for reasons started above about the absence of assets and the inappropriateness of ROCE). It should not also be confused with a single price.

56. My default tariff would be simple and it would not be regulated. Companies would charge the non-switchers: the wholesale energy costs + the network costs + the policy costs + their margin to represent their costs. Only the last element would vary (the other elements are all exogenous). The competing suppliers would offer competing margins for the services that they provide – and covering the costs they control.

57. The CMA states it is not minded to consider this option. Only one paragraph is devoted to criticising this approach – preceded by a paragraph setting out what the CMA sees as its merits.

58. The CMA states: *“However, we had significant concerns as to whether this type of remedy would, in practice, provide an adequate level of protection for customers given that a substantial proportion of customers are*

*currently disengaged*". Presumably the argument here is that the regulated tariff the CMA proposes, with its penalty headroom to ensure excess profits are earned, is a better protection? Note too that under my proposal, the OFGEM price comparison website would publish these margins (separate from the cost-pass-through elements) – if the CMA's recommendation that OFGEM perform this function was implemented. What could be simpler than publishing a list of margins? Furthermore since the margins would be transparent, if these were considered very high, the normal regulatory and competition pressures would apply. Very high margins, based upon unilateral market power, would be subject to the normal scrutiny of the regulatory and competition authorities as to whether they constituted abuse of market power.

59. The CMA then goes on to make a very confused statement. *"If awareness of the "Xs" (i.e. the default tariff levels) remained low and/or customers did not act on this awareness, then this remedy would not provide protection to customers. We considered this outcome to be reasonably likely, therefore, we are not currently minded to consider this remedy further"*.
60. This response indicates that the CMA has not understood the proposed default tariff. There is no "X". The margins and the other cost elements would be published. If the CMA's recommendation that OFGEM sets up a price comparison site were followed, then the margins would be clearly and transparently published. The margins would of course be subject to scrutiny for evidence of abuse, but not explicitly regulated. And why exactly would awareness be any greater for the CMA's temporary safeguarding tariff? The CMA gives no answer.
61. Compare the default tariff to the current situation. In my default tariff, changes in wholesale prices are passed through to customers. They are not in the current SVTs. The transmission, distribution and policy costs would be explicitly stated on bills and passed through. They are not explicit in current bills. In my default tariff, the margins would be stated – explicitly. They are not as at present. In the CMA's preferred safeguarding tariff, customers would explicitly be forced to pay the penalty headroom to provide excess profits to suppliers. In my default tariff, the profits



would come through maximising competition for the margin. In the CMA's world, the companies would compete to get customers away from the protected domain. In my default tariff world, they would compete for the default tariff customers by offering the best margins. In other words, there would be a return to the original type of competition for all these SVT customers.

62. None of the CMA's simplistic objections holds. But it is worse for the CMA's safeguarding-penalty-tariff. Who sets the headroom? Will the CMA decide the optimal level of excess profits the non-switchers will pay? Or will OFGEM? How will the excess profits vary over time? How long will headroom be set for – for the “foreseeable future” that the CMA thinks the problem of non-switching will persist? How and when will it be reviewed and reset? How will these excess profits be explained – given that there are few if any cases where the competition authorities have previously explicitly endorsed excess returns? How is this even consistent with the statutory duties of the CMA or OFGEM?

### **Downgrading OFGEM's duty to protect customers**

63. This last point might explain the foray into policy areas well beyond the normal CMA domain. The CMA proposes that the law in respect of OFGEM's statutory duties would be changed. It proposes that the promotion of competition should be given priority.
64. This has the merit of being consistent with the CMA's penalty tariff. Its rationale is to promote competition, but it is obviously not in the immediate interests of those paying a penalty for being too ignorant or stupid to switch suppliers. If OFGEM is required to protect customers as its overriding duty, it is not hard to see how the excess profits headroom would be subject to challenge.
65. Beyond this particular matter of consistency, the CMA's recommendation on the law goes well beyond the consideration of the merits of the case. In a democracy, it is reasonable to debate other social and indeed political objectives beyond competition. Competition is one means to an end –

broad social welfare. It is a political choice as to whether competition should be promoted to the role of an end in itself. In going well beyond the constraints of an energy market investigation, the CMA is in danger of damaging the broader support for the major role of competition as a means.

## **Conclusions**

66. The CMA Findings and Possible Remedies are not likely to be noted by historians of competition policy as its finest hour. The analysis is in parts weak, key parts have been either ignored or poorly researched, and the remedies are unlikely to solve the problems the CMA has identified.
67. The CMA's task has of course not been easy, but in finding that there is unilateral market power, that this has been exploited to the detriment of the bulk of customers, and that the cause as it sees it of customer inertia is likely to persist for the foreseeable future, it cannot walk away from the consequences.
68. The CMA proposals on how to bridge the gap between its desire to promote competition and its conclusion that non-switching will continue for the foreseeable future are a messy compromise and at best unsatisfactory. The CMA proposes to embed excess returns through a headroom penalty tariff. It does not help that this excess tariff is to be imposed on the most vulnerable, poorest, least educated and old in our society. They must pay to promote the general good of competition. It is a very bad confusion of ends and means.
69. There is a much better way forward, with a default tariff passing through wholesale, network and policy costs to customers plus an unregulated published margin. This avoids the problems of setting the penalty tariff (and deciding how much excess profits to charge customers, and how to review and change this over time), yet makes it utterly transparent what the margins are. It forces the companies to concentrate on what matters – the services they provide to customers on the basis of costs are under

their managerial control. It maximises competition, maximises transparency, and minimises regulation.

70. The rejection of this alternative in just one paragraph reflects a serious failure by the CMA to think through the consequences of its own regulatory solution and this alternative.
71. To go down the CMA route is to commit the industry to the agony of years of regulatory intervention. The temporary will probably become permanent “for the foreseeable future”. Trust is very unlikely to be restored. How are customers going to trust an industry, which has the CMA’s endorsement to charge headroom to create excess profits?
72. The challenge is to restore trust in this industry, to minimise the costs to customers, and make sure that the vulnerable are protected. Competition is a means, and should be concentrated on those areas where suppliers can manage and control their own costs. The default tariff proposed here does this job without lots of further regulation. The CMA’s solution is a recipe for keeping the industry on a political and regulatory battlefield. The CMA has told the customers that they are paying too much, therefore reinforcing the lack of trust that the companies had hoped this investigation would dispel. The key requirement for the restoration of trust are the explicit linking of prices to wholesale costs, the explicit setting out of the network and policy costs, and the publishing of the margins.