

The return to price caps:
Where did it all go wrong
and how to fix it?

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Beesley Lecture, London

5 October 2017

Opening remarks

- Michael Beesley
 - What would Michael think?
 - Meddling/nannying
 - Joseph Schumpeter, Austrian economist
 - competition as “a perennial gale of creative destruction”
 - Where the action is
- George Best
- Personalities and institutional factors

Outline

- The story so far
- Price control solution? Overseas evidence
- Ofgem: diagnosis and remedies
- CMA's customer detriment calculation
- CMA: remedies
- Economics and remedies
- Conclusion

Background 1998-2008

- Retail competition conceived (1983/4) as way to transfer benefits of generation competition to customers
- Without need for Government or regulation
 - Franchise until 1998 was a means of protecting (& privatising) coal sector at customers' expense – indicated importance of retail competition in protecting customers
- Would retail competition work? Unknown
 - 1998 transitional price cap, removed 2002
 - “The evidence is overwhelming that competition is effective across all social groups and all methods of payment” Ofgem
 - Competition continued to develop
- Jan 2008 “Market is sound, Ofgem assures Chancellor”

Developments 2008 - 2014

- Feb 2008 Ofgem Probe “to address mounting concern among customers”
 - Few customers engaged, “unfair price differentials”
- 20 measures to promote more engagement
 - Especially non-discrimination condition SLC 25A
- But these measures didn’t seem to work
 - 2010 Maybe restriction to 1 tariff? (Procrustean Bed)
- 2012 Simple Tariffs (max 4, most discounts banned)
- But there were still concerns
- 2014 Ofgem referred sector CMA market investigation
 - Ofgem identified five issues for examination

Jun 2016 CMA Final Report

- Four of Ofgem's five identified issues not a problem
- Ofgem's Simple Tariffs policy had an Adverse Effect on Competition (AEC) – remedy was Ofgem remove it
- “Weak customer response” AEC - gave suppliers market power, exploited via level of prices & price discrimination
 - Customer detriment average £1.4bn pa, £2bn in 2015
- Remedies for weak customer response AEC
 - Promote greater customer engagement
 - including Disengaged Customer Database
 - Price cap for PrePayment Meter customers (16% of total)
 - Minority report: extend price cap to Standard Variable Tariff (SVT) customers (about 70% of total)

Latest developments 2017

- Jan: Sec of State says £1.4bn customer detriment “huge”, are CMA measures sufficient?
- Feb/Mar: price increases by most large suppliers
- Mar: Parliament All-Party motion calls for more action
- Apr: PM calls election, cites £1.4bn detriment, proposes cap on SVTs to curb “rip-off energy tariffs”
 - Election manifestos propose stronger action than CMA
- Jun: Sec of State asks Ofgem what action it will take
 - Ofgem: extend price cap to vulnerable customers in 2018
- Sept: “Parliamentary pressure mounts” – 1/3 MPs letter
 - “Business secretary Greg Clark has given the energy regulator Ofgem a final warning to eradicate £1.4bn of “excessive” annual charges by power companies” (FT)
- 4 Oct: PM - Bill to order Ofgem to impose price control

Would price control fix problem?

- Assume CMA calculation of £1.4bn/£2bn customer detriment
- Is price control remedy appropriate?
- **CMA Majority says NO:**
 - “attempting to control outcomes for the substantial majority of customers would undermine the competitive process, potentially resulting in worse outcomes for customers in the long run. ... a combination of reducing the incentives of customers to engage, reducing the incentives of suppliers to compete, and an increase in regulatory risk ... it inevitably increases the risk of further such interventions in the future”
- **CMA Minority says YES:**
 - “The harm which is presently inflicted on households in this market is very severe ... the remedies will take some time to come into effect, and are in any case untried and untested. .. none of these [previous] developments has made a dent in the proportion of customers of the six large energy firms (about seven out of ten) which remains on the standard variable tariff (SVT)”

How to resolve this difference of view?

- Both good points – pity two sides did not engage more
- CMA Minority: Can we use both remedies?
 - “This is a question which ultimately has to be resolved not theoretically but on the basis of experience and other empirical evidence.”
 - “I observe that in other liberalised sectors, and in energy in Great Britain and more recently in several Australian states, both remedies were used in tandem, and then the caps were successfully removed - precisely because customer engagement was judged to have developed under an appropriately designed price control.” (CMA Report, Dissent, p 1415)
- But that was when markets were first opened – is there evidence from other competitive markets are today?

Two overseas markets

- Feb 2016 New York: Few supplier offers better than regulated rate. Order: suppliers only allowed if can *guarantee* savings over regulated rate
 - Order suspended pending review, meanwhile suppliers banned from supplying low income customers
- Aug 2017 Thwaites Review, Victoria, Australia: customers not well served by competition
- Proposes regulated price for Basic Service Offer
 - No plan to remove this price cap later
- So, recent experience not for removing price caps

CMA on Ofgem

- CMA found Ofgem's policies had AEC & should cease (above)
- CMA also found several problems with sector governance
 - “an overarching feature of a lack of robustness & transparency in regulatory decision-making which, in turn, increases risk of poor policy decisions which have an adverse impact on competition”
- Ofgem's statutory objectives are an actual or perceived constraint on its ability to promote competition
 - para 1C (try anything before promoting competition)
- CMA solution: remove para 1C
- Lack of understanding of factors that led to price increases
- CMA solution: suppliers to provide more financial information, & Ofgem to provide more reports
- These seem sensible reforms – but will they be sufficient?

Government influence

- Possible Government influence on Ofgem
 - “possible that institutional pressure from DECC was one of the factors behind one or both of these [Ofgem] decisions” (18.35)
 - “DECC has a number of tools that it can use to influence Ofgem’s actions” (18.40) including Govt appoints GEMA (18.39)
- CMA solution: Joint Ofgem/DECC statements, Ofgem to comment publicly on draft legislation, Govt should issue Strategy & Policy Statement
 - Draft Statement 2014: Aim “Ensure regulatory framework would deliver against our strategic objectives”. Ofgem duty to best further delivery of Govt policy outcomes, explain how it is doing this, whether it has succeeded and how do better next time.
- Will this remove/reduce Govt influence? Or opposite?
- Note that public pressures on Ofgem also very great

Context: energy prices doubled 2004-09



Media & other pressures

- Media & other pressures early 2008
 - Mar 2007 Energywatch: “Ofgem has been complacent at best and negligent at worst”
 - 15 Jan 2008 Ofgem “Market is sound”
 - 5 Feb 2008 Sel Committee announces investigation
 - 21 Feb 2008 Ofgem announces Probe
 - 16 July 2008 Sel Cttee: “Ofgem will need to demonstrate rather greater sense of urgency than has been made apparent so far”
- Is anything different today? (e.g. *Utility Week* 12 Sept 2017)
 - “Clark puts pressure on Ofgem over price cap” (headline)
 - “If Ofgem don't have the guts to use their powers to go into battle on behalf of consumers, they should be replaced by a regulator which isn't scared to do its job.” John Penrose MP
 - Sec of State says “This is Ofgem’s last chance” (2 Oct 2017)
- Further distancing conducive to better policy

Ofgem trying to reduce regulation

- Ofgem aim to reduce supply licences (grown 70 - 500 pages)
- Encouraging suppliers to take responsibility
 - “Important [that] suppliers are doing the detailed thinking about what customers need. Not a team of civil servants in Ofgem.”
- Treat Customers Fairly Principle instead of detailed rules
 - But Ofgem proposes to “flag areas the industry or particular suppliers might need to pay attention to ”
 - What would Michael think? Nannying?
 - “Help [suppliers] understand and apply *our principles* in their businesses - this will help develop a more consumer-centric culture in the industry.”
 - Or will it help develop a more regulator-centric culture?
- Ofgem concern that suppliers are still mainly focused on managing risk of enforcement under a principles regime
 - But such risk management concerns seem understandable
 - £220m in fines & redress payments since 2010
 - Ofgem’s future interpretation uncertain, especially given pressures

A more radical approach

- Why does retail energy have to be a special case, rather than be governed by general consumer protection and competition legislation?
- **Remedy 1:** remove obligation for supply licence
 - Licence convenient? Or is that the problem?
- Still have investigations by Ofgem or CMA
- And whatever obligations deemed necessary
- But would reduce immediate pressure on Ofgem
- It would become Ofgen: Office of Gas & Electricity Networks, reporting to GENA

CMA and customer detriment

- Customer detriment average £1.4bn per year (2012-15)
 - Election manifestos, cited by PM & SoS, used to pressure Ofgem
- £1.4bn detriment a life of its own - but how soundly based?
- CMA aimed to compare prices: Big6 v 2 mid-tier suppliers
- But made substantial adjustments to ensure comparability
 - “10.27 We have based our assessment on the principle that ... a **competitive benchmark price** ... should be reflective of the costs of an **energy supplier which has reached an efficient scale** ... and which is **in a steady state** ... and it should generate revenue that is consistent with a **normal return**”
 - “**10.2 [This] is not an idealised perfectly competitive market**”
- ? Audience can decide on that
- Detriment is comparison with hypothetical efficient state

Detriment calculation

- Big6 claimed unrealistic & too high (naturally)
- Oxera (March 2017) advising SP:
 - Correct detriment in range minus £720m to plus £755m. Significant difference of opinion
- More important is lack of transparency. Oxera:
 - CMA made 2 final adjustments not made previously
 - These adjustment c.£1bn. After closure of data rooms
 - So no-one could see details of CMA calculation
 - CMA could not benefit from comments on its process

Were there excess profits?

- CMA also had indirect approach to customer detriment: excess profits + inefficient costs
 - average £303m + £420m = £723m (longer period 2007-14)
- Excess profits (usual CC calculation) ave £303m
 - Suppliers challenged (naturally)
- But by standards of I&C market, no excess profit
 - CMA uses benchmark EBIT margin 1.25%
 - Risk-adjusted EBIT margin in I&C market is 2.4%
 - Applying I&C standard in domestic market worth £300m - would remove domestic “excess profit”
- I&C market competitive: didn't need investigation

Profits not across the board

- Are profits specific to particular firms?
 - “6.152 In order to be indicative of a failure of competition, profits in excess of the cost of capital ... should also not be specific to a particular firm; we would expect that suppliers who are particularly innovative or efficient will realize higher profits than others in the same market.” (CC Rolling Stock Leasing, 2009)
- BG had 2/3 total sector retail profits, BG+SSE 95%
- 4 Big6 profits below CMA competitive level, 2 had losses
 - Ofgem Segmental statements 2009-2014
- BG & SSE problem? No, were more effective competitors
 - growing market share until 2008 and lowest costs
- Industry profits do not indicate “failure of competition”
 - Profits not attributable to sector-wide “weak customer response”

Inefficient costs?

- Inefficient costs average £420m pa 2007-14 (or £290m)
 - Difference between actual costs & lower quartile costs
- But is this justifiable basis for detriment?
 - Cost differentials exist in all real competitive markets – costs are only equal in theoretical perfect competition model
 - Is competition in the capital market not working?
- Has been considered by CC but previously limited
 - SME Banking 2002: only one bank inefficient, 15% total detriment
 - CC Groceries 2008: “two of the major parties had higher costs than the other three ...In both cases, there was clear evidence that profitability had suffered accordingly, so that shareholders rather than consumers were bearing the consequence.” (2.153)
 - Contrast CMA Retail energy: “large part of detriment likely due to inefficiency rather than excess profits” (11.90) No adjustment for unprofitability of two energy retailers

What's gone wrong & remedy?

- Conclusion: £1.4bn detriment questionable
 - Guess at prices if suppliers had hypothetically lower costs
- But actual profit data (& other factors) consistent with this being a competitive market
- What has gone wrong is not competitive market, but CMA analysis leading to £1.4bn detriment
 - In other respects, CMA report is good
- How to fix this?
- How to make CMA analyses more soundly based?

Access to CMA data

- CMA needs to call a halt at some point, but must make time for full challenge within investigation
- **Remedy 2:** As long as further CMA modifications significant, allow data room access & comments
- **Remedy 3:** Open data room to allow inspection after final remedies published
- But confidential data room alone is not sufficient
 - Expensive, & access limited to few large suppliers
- Need wider public understanding of calculations

Excisions of data

- CMA has to balance understanding & business interests
 - The Commission report shall contain such information as the Commission considers *appropriate for facilitating a proper understanding* of the reasons for its decisions. EA 2002 (s 136)
 - If information disclosure would significantly harm the interests of an individual or a business, the Commission must consider *whether disclosure is necessary to facilitate a proper understanding* of its reasons and decisions (s 244)
- Extent of excisions in CMA Energy Report?
 - Unusual? CC SME Banking 2002, CMA Banking 2016
 - But not conducive to proper understanding or appraisal
- **Remedy 4:** *Either* CMA finds a way of limiting excisions so as to “facilitate a proper understanding”
- *Or* need to change Enterprise Act provisions

Appeal

- There is possibility of appeal against CMA decisions
- £1.4bn detriment calculation controversial & questionable
- But it is not a “decision” that can be appealed
- Also, grounds for appeal are limited, related to process
- CC/CMA reports cannot be appealed on merits
 - “Market investigations ... [remain] the view of a ... body who conduct their business behind the shelter of substantive immunity. This remains an unsound basis for regulation. ... this situation will inevitably have to be revisited at some stage in the future” (Freeman 2002)
- **Remedy 5:** Widen basis of appeal in market investigations to include appeal on merits

Competition policy reform

- Fair Trading Act 1973
 - Complex monopoly: Do two or more persons prevent, restrict or distort competition? If so, is it against public interest?
- This 2-stage process considered cumbersome
- And wish to avoid reliance on public interest
- Enterprise Act 2002
 - If any market feature (structure, conduct or customer conduct) prevents, restricts or distorts competition, it constitutes an AEC
- Generally welcomed (by competition authorities)
 - Does it make it “too easy” to identify AECs?

Public interest issues

- But how to deal with public interest concerns?
 - Sybil Fawcety?
 - Or the man with a hammer?
- CMA can only address if it finds anticompetitive
 - Unless can use wider duties of regulatory body
- Could compromise economic analysis of competition?
 - Define well-functioning market to reflect public interest concerns?
- (Re)distributional issues (eg social tariffs) matter for Government? Should CMA be able to comment?
- **Remedy 6:** Reconsider Enterprise Act 2002 re non-existent role of public interest in market investigations

CMA = OFT + CC

- 2011 Coalition Govt Policy:
 - “more proactive & consumer-focused interventions”
 - Merge OFT+CC=CMA “to play leading role in achieving over-arching objectives & delivering desired outcomes”
 - Joint working between CMA & sector regulators
- 2013 Enterprise & Regulatory Reform Act
 - 2013, 2015 Govt Steer to CMA to reinforce aims
- CMA very active, many aims achieved
 - More effective in proactive OFT-type role?

Effects of policy

- But has CMA lost CC's 'ability to stand back' detachment?
 - Much emphasis by Govt & CMA on doing more faster
 - But any emphasis on better analyses & judgements?
- Importance of regulatory input into CMA reviews
 - Contrast to companies which have own interests
- But does cooperation diminish their independent challenge to CMA thinking? Contrast an earlier occasion with CC & CAA
 - Cf “the CAA is not convinced by the CC’s arguments” (2.10) “the CAA considers that the CC’s recommendations for Stansted are unduly stringent” (2.21) “The CAA does not propose to adopt the CC’s recommendation ... The CAA does not concur with the CC’s approach and assumptions” (2.27) (CAA Nov 2002)
- Is justice seen to be done if parties are “ganging up”?
- **Remedy 7:** Reconsider merger of OFT+CC, and drop requirement for CMA to work with regulators

Behavioural economics

- Has become increasingly influential
 - Ofgem Probe 2008 first major use of behavioural economics?
 - OFT 2010 Implications for competition policy
 - 2013 CC/CMA revised Guidelines mentions 50 times
 - 2013 Govt Steer to CMA
 - “consumer behavioural issues should be central to the CMA’s analysis ... and inform the remedies”
- Shows conventional economic assumptions unrealistic
 - Contrast homo sapiens and homo economicus
- And has led to useful operational suggestions
 - Behavioural Insights Team/Limited (Nudge Unit)
- But has it been an unmitigated blessing to regulators?

Misuse of behavioural economics

- Instead of using these insights to reform economics, economists have tried to reform people
 - Aim to turn homo sapiens into homo economicus
 - To correct for “behavioural biases” (eg loss aversion, status quo bias)
 - Inactive customers are an inferior form of active customers
- Misleading policy implications
 - E.g. Markets require “confident customers, adept at exercising choice” (BIS 2010) “Competition only works for active customers”
 - Should eliminate SVTs? But for many customers they are the solution
- Undue focus on weak customer response/engagement
 - 410 mentions in CMA Energy Report
- Switching has become an obsession
 - CMA Energy 4785 mentions, CMA Banking 3162
- Customer failure but little acknowledgement of regulatory failure
- **Remedy 8:** Reorient behavioural economics to reforming economics rather than reforming customers

Competition & CC/CMA Guidelines

- CC Guidelines 2003 para 1.16
 - “the Commission sees competition as a *process of rivalry* between firms or other suppliers ... seeking to win customers’ business *over time*.... Whatever forms the process of rivalry takes, the Commission will consider its effects over time”
- CC/CMA Revised Guidelines 2013 para 10
 - “Competition is a *process of rivalry* as firms seek to win customers’ business.”
 - “the CC defines such a benchmark [against which to judge an actual market] as ‘a well-functioning market’ ... but *not an idealized perfectly competitive market*.”
- What do the CC & CMA do in practice?

Competition & CC/CMA Reports

- Actual reports CC/CMA reports characterised by
 - Variety of different approaches
 - Little or no emphasis on process over time
 - Benchmark basically idealised perfectly competitive market
- What CC/CMA practise is opposite of what they preach
- Why? Because process isn't in the economics textbooks and perfect competition is
 - Johansson & Malm, *Econ Journal Watch*, May 2017
- Qualifying as a professional economist requires ability to explain why perfect competition is the benchmark without reference to any process of rivalry over time

Remedies in Economics

- Require CMA to use textbook definition of competition? No
- Economics textbooks should adopt CC/CMA definition (or similar)
- **Remedy 9:** Rewrite Economics textbooks
- This will probably also require
- **Remedy 10:** Retrain the Economics profession
 - Admittedly, these remedies “will take some time to come into effect, and are in any case untried and untested “ (CMA Report p 1415)
- But is there a glimmer of hope?

The latest economics textbook

- *The Economy*, textbook by CORE, OUP 10 Oct 2017
 - “In response to student allegations of irrelevance of economics”
 - Opening chapter headings:
 - 1 The capitalist revolution 1.1 Inequality
 - Says essential concept to understand inequality is Fairness
- Schumpeter ch 2.5: dynamism of capitalism, innovation rents, creative destruction, entrepreneur
- Hayek ch 11: prices are messages, meaning of competition, dispersal of knowledge
 - “One of three great thinkers, whose key ideas transformed how we now understand the economy. ”
- But don't get too excited
 - about 500 Glossary definitions do not include Competition
 - but do include 50 references to equilibrium

Conclusions

- UK retail energy market is broadly competitive
- But has been misdiagnosed as not competitive
- Don't need more switching or price controls
- Need remedies to regulation & competition policy
 - Focus on reducing political & other pressures on regulators/competition authorities, and increasing the challenge to their analyses
- Also need to rethink behavioural economics & competition – but why wait for economics profession?
- **Remedy 11:** Let CMA review its use of behavioural economics and its concept of competition
- Final story (Steven Pinker, *Sense of Style*, 2014 p 154)