

To Rachel Reeves MP, Chair
BEIS Select Committee
House of Commons

17 November 2017

Dear Chair

We write as former GB energy regulators in response to the Committee's invitation to submit evidence in connection with its pre-legislative scrutiny of the Government's draft Domestic Gas and Electricity (Tariff Cap) Bill.¹

There are three main concerns that we wish to draw to your attention. They relate to the Objective, Provisions and Impact of the proposed legislation.

1. The CMA's calculation of £1.4bn customer detriment, on which the need for the draft Bill is predicated, is artificial, misleading and inconsistent with previous UK competition policy assessments.
2. A price cap set to remove such alleged detriment will have a serious adverse impact on competition and hence on customers.
3. The draft Bill's proposal to require Ofgem to impose a price control without power of appeal is inconsistent with the tradition on which UK utility regulation has been developed over the last 35 years.

1. The CMA's calculation of £1.4bn customer detriment

It seems to be widely assumed that the CMA's calculation of £1.4bn annual customer detriment refers to retail prices set at an unduly high level as a result of excess profits and market power of the "Big 6" retail energy suppliers. This is not the case.

The CMA's £1.4bn detriment figure is based on a comparison of prices actually charged by large retailers over the last few years with the CMA's calculation of what a purely hypothetical supplier "at an efficient scale" and "in a steady state" would charge in a hypothetically competitive market. It is thus not a calculation of excess profits, it is a calculation of what prices might be like in a different world.

Suppliers strongly challenged the plausibility of these calculations. Oxera, as consultant for one supplier, pointed out that, after final comments were received from interested parties, the CMA

¹ All of us have had executive responsibility for energy regulation – and specifically regulation of retail competition - at the highest levels in Ofgem and its predecessor bodies Ofgas and Offer. Our combined executive experience covers the period from 1989 until October 2010. In addition, we are all trained economists with extensive experience of applying economics in regulatory practice, including in other regulated sectors in the UK and elsewhere.

made further adjustments, of the order of £1 bn. These were never made available for examination in the data rooms, or subject to comment and criticism.²

In assessing customer detriment, competition authorities would more normally calculate excess profits. The CMA made such a calculation, which estimated such excess at an average of £303m per year. This naturally depends on a comparison with what is considered a normal competitive return. The CMA indicated that the domestic (residential) market was more risky than the market for large industrial and commercial customers. The difference was of the order of £300m per year. In other words, judged by the standard of the large customer market – which was deemed so competitive as not to warrant investigation – the domestic market did not exhibit excess profit.

The Competition Commission explained that “in order to be indicative of a failure of competition, profits in excess of the cost of capital ... should not also 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”. (Rolling Stock Leasing Report, 2009)

In the present case, profits *are* specific to particular firms. Over the period that the CMA studied, BG accounted for no less than two thirds of the total retail profits, and BG plus SSE accounted for 95% of them. Ofgem data show these to be the two most efficient suppliers. Of the other four Big 6 suppliers, two had profit rates around or below what the CMA considered to be the competitive level, and the other two on average made losses.

Thus, industry profit rates do not indicate a failure of competition, and cannot be explained – as the CMA claims - as a sector-wide consequence of “weak customer response”. Firms consistently making losses cannot be deemed to have undue market power.

Differences in efficiency are not exceptional, they are the norm in competitive markets generally. The CMA’s undue reliance on inefficient costs is a serious weakness in its approach. In a few exceptional cases in the past the Competition Commission has made reference to inefficiency as a possible consequence or indication of market power. But in one case the extent was minimal (15% of calculated total detriment). In another case the Commission noted that the inefficient firms made losses so that shareholders rather than customers were bearing the consequences, so that it did not pursue this issue.

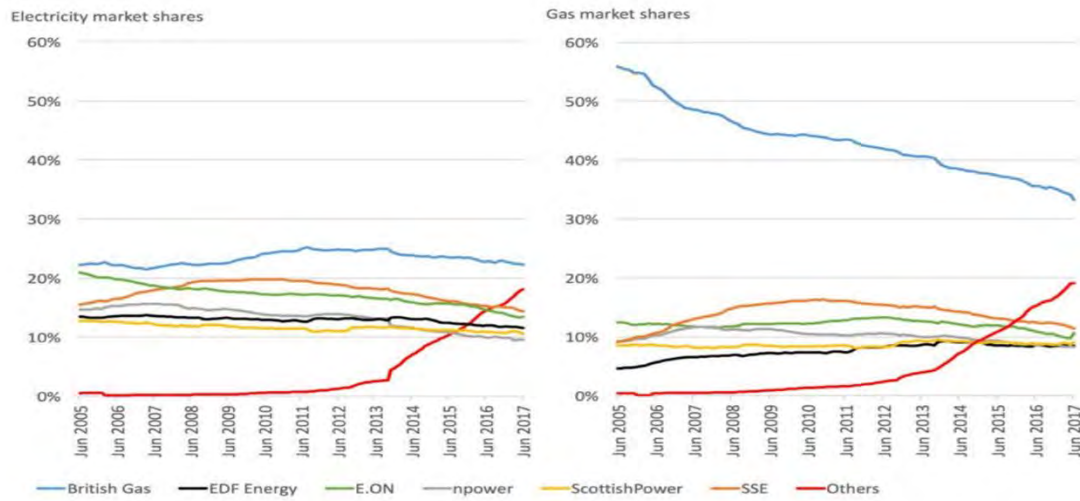
The CMA took no account of these precedents. Indeed, it acknowledged that “a large part of the detriment we have observed in the form of high prices is likely due to inefficiency rather than excess profits”. (CMA *Final Report* para 11.90) We are not aware that any UK competition authority (or any such authority internationally) has based a conclusion of customer detriment on such a calculation.

² Oxera, *CMA energy market investigation – critique of CMA consumer detriment analysis*, Prepared for Scottish Power, March 2017.

2. The adverse impact of a price cap

Competition in the domestic retail energy market has developed particularly strongly since the period studied in the CMA report. The switching rate is now nearly 20% in the last year, equal to the highest level ever attained (back in 2008). The share of the market taken by the new entrants (non-Big 6 suppliers) has doubled from about 10% to nearly 20%. (Ofgem, *State of the Energy Market 2017*) Both factors are putting increasingly severe competitive pressure on the Big 6. It seems a particularly inopportune time to disrupt these important developments of competition.

Figure 2.2 Electricity and gas market share evolution



Note:
Data correct as of June 2017.

Source:
Ofgem analysis of Distribution Network Operators and Xoserve data.

The CMA explained why an extensive price cap would have adverse consequences for customers, hence why the CMA majority were opposed to it.

“... attempting to control outcomes for the substantial majority of customers would – even during a transitional period – undermine the competitive process, potentially resulting in worse outcomes for customers in the long run. This risk might occur through a combination of reducing the incentives of customers to engage, reducing the incentives of suppliers to compete, and an increase in regulatory risk.” (CMA *Final Report* p. 656)

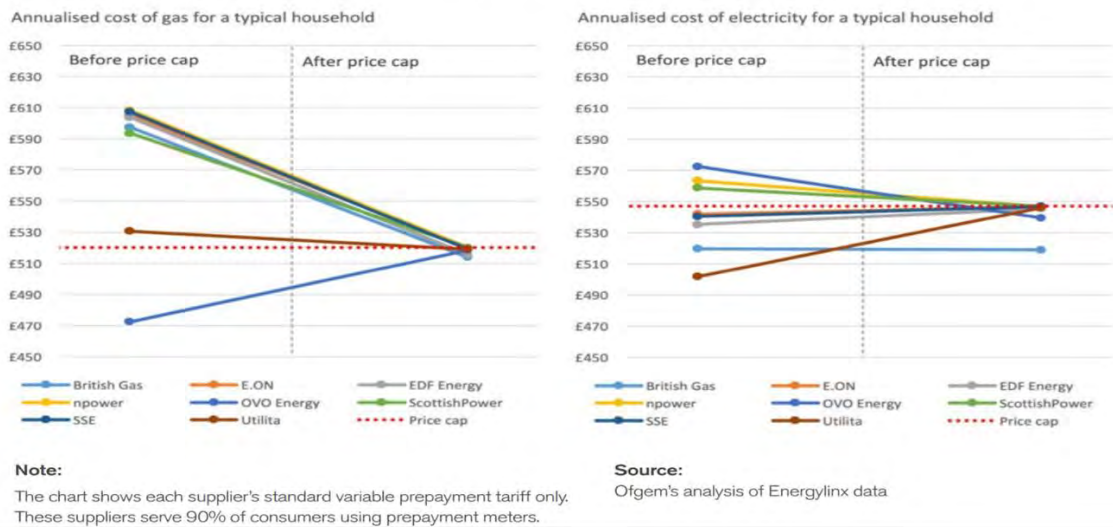
The severity of the adverse consequences depends on the level and severity of the price cap. After the CMA observed (as just noted) that “a large part of the detriment we have observed in the form of high prices is likely due to inefficiency rather than excess profits”, the CMA continued “such that if we were to eliminate the detriment we have observed through a price cap it would create substantial losses for the sector as a whole”.

It is one thing to impose a price control to eliminate excess profit. The pros and cons of this are debatable, as indicated. It is quite another thing to impose a price control to “create substantial losses for the sector as a whole”. It has not been a UK tradition to impose such loss-making controls. And if such controls are imposed on the retail energy sector, what is to stop such precedent being used to impose them on other sectors that are claimed to be inefficient?

There is also a conflict with the proposed criteria in the draft Bill. Section 1(6) requires the Authority to balance five considerations, relating to protecting customers, creating incentives to efficiency, enabling effective competition, maintaining incentives to switch and ensuring ability to finance licensed activities. A price control that seeks to eliminate the entirety of the alleged customer detriment of £1.4bn – as the Secretary of State seems to have suggested – will be inconsistent with these considerations.

Ofgem’s illustration of the impact of the recent price cap on PPM tariffs indicates the likely consequences of such a price cap on SVT charges. (*State of the Energy Market 2017*)

Figure 2.13 Prepayment tariffs before and after the price cap



Even setting aside ability to finance licensed activities, a “market” in which all suppliers are constrained to charge approximately the same price is inconsistent with enabling effective competition and maintaining incentives on customers to switch.

3. Government imposing a price control

Several of us were actively engaged in the early development of regulatory arrangements to enable the many industry privatizations and the restructuring arrangements to enable and facilitate competition. These extended over several parliaments and involved governments of different parties. Throughout this period there was a conscious concern to develop governance arrangements that appropriately balanced the interests of shareholders and customers, and that provided incentives on companies to invest in – and to continue to invest in - these large and critically important markets. The UK approach has provided a model for many other countries.

These governance arrangements have had at least two consistent themes. The first is the concept of independent regulation. The regulatory body has statutory powers and duties, and is responsible to Parliament. It is not an instrument of Government that takes orders from the Government or is responsible to Government.

The second theme is that it has always been considered necessary to assure investors that Government will not simply step in and expropriate profits or impose unreasonable price controls

or other serious restrictions that could jeopardise the interests of investors and ultimately consumers. Rather, a process was established whereby independent regulators with statutory duties – not Governments - could propose license modifications, and if regulated companies did not accept them they could be appealed to the independent competition authority. Over time, these arrangements have been modified. In some sectors or circumstances there is now provision for independent regulators – not Governments – to impose certain licence modifications. However, this is without removing the ability of the regulated companies to appeal to the competition authority.

The draft Bill ignores and overrides both of these long-standing protections. It undermines the concept of independent regulation by ordering the regulatory body GEMA/Ofgem to impose a price control of the Government's own design. And it removes the conventional appeals procedure normally open to regulated companies against a regulatory proposal of such kind. Although it leaves open the possibility of judicial review, that has always been conceived of as an additional and somewhat basic protection to regulated companies. Judicial review has never been conceived of as sufficient in itself to provide the protection provided by independent regulation and conventional appeal procedures on matters of substance as opposed to legal due process.

4. Conclusions

In light of the above arguments, we urge the Committee

- a) To examine closely whether there really is sufficient customer detriment in the retail energy market to warrant a remedy as severe as a price control on all standard variable tariffs;
- b) To make it clear that any such price control should not be based on an expectation that it would seek to reduce such tariffs by anything like £1.4bn per year; and
- c) To urge that the eventual Bill provide more recognition and scope for regulatory independence of GEMA/Ofgem in deciding on the need for, scope of, and nature of, any further price control, and make explicit provision for regulated companies to appeal to the CMA or Competition Tribunal on matters of substance.

From:

Stephen Littlechild, Director General of Electricity Supply and Head of the Office of Electricity Regulation (Offer) 1989-1998

Sir Callum McCarthy, Chairman and Chief Executive of Ofgem and the Gas and Electricity Markets Authority (GEMA) 1998-2003

Eileen Marshall CBE, Director of Regulation and Business Affairs, Offer 1989-1994; Chief Economic Adviser and later Deputy Director General of Ofgas 1994-1999; Managing Director, Ofgem and Executive Director, GEMA 1999-2003

Stephen Smith, senior executive positions at Ofgem 1999-2002 and 2003–2010 including Managing Director, Markets, 2004-2007 and Executive Board Member, GEMA 2004- 2010

Clare Spottiswoode CBE, Director General of Gas Supply and Head of the Office of Gas Regulation (Ofgas) 1993–1998.