

George Yarrow

## **Submission on the CMA's Summary of Provisional Findings Report and Notice of Possible Remedies**

This short submission is directed at the CMA's provisional finding that, in domestic retail energy markets, there exists "... a combination of features of the markets ... that give rise to an AEC through an overarching feature of weak customer response", and with (i) the similar, related finding in relation to unilateral market power and (ii) the associated possible remedy of introducing a price capped 'safeguard' tariff. To address the issues it is necessary to go back into some of the economic mechanisms at work, though the relevant points are made in highly abbreviated ways. The submission is complementary to that of the former regulators ("FRs"), with whose views it is generally aligned.

### ***The finding in relation to weak consumer response***

The first thing to say is that the language used in expressing this finding is less than clear. The concept of an *overarching* feature appears novel and it is not easily linked either to statutory language or to economic language. Footnote 449 of the (full) Provisional findings report says that 'overarching feature' is "*synonymous with it being a source for an AEC*". That raises the question of what is meant by 'a source'.

If by 'source' is meant something that 'gives rise to', then weak customer response is a simply a particular feature or combination of features (which needs to be explicitly identified), but the reference in footnote 449 to paragraph 170 of the Competition Commission's Guidelines for market investigations suggests this is not what is intended. What *is* actually intended is not entirely clear.

Paragraph 170 of the Guidelines is concerned with theories of harm, an approach to matters that has distinct weaknesses for market investigation purposes. The paragraph seems to be trying to establish a *simplified classification scheme* for a wide range of factors/features that can influence competitive conditions. One of the categories in this labelling/classification exercise is 'weak customer response', concerning which paragraph 170 refers back to paragraph 15 of the Guidelines. Paragraph 15 gives only a very limited number of disparate examples of the sorts of things to which this label might be applied, such as lack of information and lock-ins that impede customer switching.

On this basis, the 'overarching feature' of weak consumer response is not itself 'a feature', but rather a *set* of features that have something in common. If this is correct, 'weak customer response' is not something that gives rise to an AEC that might stand in need of remedy.

That is how it should be: a wide range of markets are characterised by the existence of sub-sets of consumers who are significantly less responsive to changes in the prices or qualities of products and services on offer than are other consumers (and the provisional findings rightly recognise that responsiveness is not a binary variable: different consumers exhibit a

range of different response elasticities). There is no reason to believe that there are AECs in consequence of this fact alone.

However, by referring to weak consumer response as a 'feature' of retail energy markets, albeit qualified by the adjective 'overarching', the language is liable to mislead, imparting a bias into the way that matters are assessed. It invites the presumption that weak customer response itself gives rise to or causes AECs and that it is itself a problem or feature of the market that should be addressed.

Parts of the provisional findings documents can be read this way, and they have been interpreted by some commentators as the CMA saying that consumer choice is itself a problem and that it needs to be changed (to eliminate AECs), rather in the manner of politicians blaming the electorate for the 'false consciousness' that led them to vote for the other lot ("they didn't understand our message"). It is, therefore, difficult to over-emphasise the point that any presumption that 'weak customer response' is necessarily, or even frequently, a problem is unwarranted, for reasons given below.

A root cause of the difficulties in interpretation is the vague and imprecise notion of 'weak customer response' itself, which dilutes the analytic power of the normal economic concept of demand elasticities. To illustrate, consider a situation in which consumers have difficulty in distinguishing between the different qualities of different products on offer for want of relevant, reliable information about quality. That might lead to the situation being classified as one of 'weak consumer response'. However, in the assumed situation consumers might come to focus heavily on price, precisely because it is more easily observable, and tend toward simply opting for the lowest price on offer. Cross-price-elasticities of demand may therefore be very high, which might reasonably be labelled 'strong consumer response'.<sup>1</sup> The generic label, 'weak customer response', fails to distinguish between things that differ and is an impediment to clear thinking and analysis.

In the absence of the muddle introduced by the over-generalised concept of 'weak consumer response' it would be much more straightforward to go straight to the relevant questions and issues. Do information conditions make it difficult or costly for consumers to get information about the qualities or prices of different products on offer? What are the economic effects of these high information-acquisition costs? Are there feasible measures that could improve matters?

A second bias that can potentially be imported via the novel notion of an 'overarching feature' is also worth noting in passing. The relevant Statute pushes the CMA toward finding *comprehensive* remedies. I personally think that this aspect of the legislation is problematic, but it is as it is and the CMA must comply.

Given the Statute, by framing things in terms of an 'overarching feature' an assessment bias is imparted toward searching for remedies that seek to address 'weak consumer response'

---

<sup>1</sup> The hypothetical situation illustrates how, consistent with Hirschman's general line of reasoning (see below), customer price responses can become 'too strong'. In focusing heavily on price, consumers might forego higher quality, higher price alternatives that would have delivered greater value (consumer's surplus). This is an economic point that I have found all decent lawyers understand very readily.

in a comprehensive way. That in turn biases things toward over-regulation, which is ironic in a situation where the provisional findings, consistent with the evidence, indicate that past regulatory decisions have given rise to AECs.

The broadening of the notion of a ‘feature’ imported via the word ‘overarching’ also creates unnecessary tensions between domestic and EU law, which will be a potential source of problems if the price-capped safeguard tariff option is progressed. Domestic law may require the CMA to find *comprehensive* remedies, but EU is much focused on *proportionality*. Not only is EU law superior to domestic law, it is also based on much better economics.

The issues are summarised in a recent Utility Week article by Gordon Downie, who writes:

*“In its celebrated Federutility ruling of April 2010, the Grand Chamber of the European Court declared that it followed from the very purpose and general scheme of the Gas Directive (and by implication its sister Electricity Directive) that the price for the supply of natural gas (and electricity) must be determined solely by the operation of supply and demand. While member states have the ability to derogate from that basic principle, for example in the name of consumer protection, the upshot of Federutility is that the member state will have the difficult task of justifying the derogation on proportionality grounds by demonstrating that:*

- the intervention is limited in duration to what was strictly necessary in order to achieve its objective (which means more than simply labelling the measure as temporary and would, for instance, require periodic re-examination of the necessity of the intervention);*
- it goes no further than required in order to achieve the objective being pursued, that is, by ensuring that it is tailored to address only [my emphasis] the effects of the particular market failure that the member state might be able to identify;*
- it takes proper account of the categories of beneficiary supported by the intervention and any objective differences between them that might call for difference in treatment.”*

In anticipation of the discussion of the possible price control remedy below – and, notwithstanding paragraph 92 of the Notice of possible remedies, price control by any other name is price control – attention is drawn to the second and third bullet points. The second condition allows a remedy to be ‘comprehensive’, but only to address something specific and identifiable. That is, the intervention also has to be *targeted*. The third condition, consistent with the notions of proportionality and targeting, calls for a careful examination of differences among sub-groups who might benefit from the remedy and for consideration of whether there are remedies that are better adjusted to these differences.

If the CMA were to proceed with such a price-cap remedy, these requirements call for a work programme that goes significantly beyond anything that has been done up to this point.

### ***Inter-consumer variations in price-responsiveness***

Consumers exhibit variations in price-responsiveness for a whole variety of reasons, both individual and social (from experience, there tends to be a systematic neglect of the latter arising from a tendency/bias toward thinking of consumers as deracinated beings, which they are not<sup>2</sup>), and these differences exist for products and that are physically homogeneous or near homogeneous<sup>3</sup> as well as for differentiated goods. If that is doubted, just a little bit of shopping around – in a high street, local shopping centre, or on Amazon – should erase the doubt.

It is unlikely that the CMA would find that ‘weak consumer response’ was a feature, overarching or otherwise, likely to give rise to AECs in the many markets where there exist significant, non-transitory price differences for like products. It would, rightly, recognise that revealed preference indicates that there are (usually numerous) things other than price that influence the purchasing decision, even among those consumers who most closely resemble *homo economicus*.

Even if those other things were absent, introductory, static economic theorising demonstrates why the existence of less price responsive consumers is not necessarily a competition issue, because it is *marginal* demand that matters for price determination.

---

<sup>2</sup> This observation prompts the following thought, relevant to another of the CMA’s possible remedies. It is difficult to see much benefit from establishing an Ofgem PCW. It would replicate services that are already being offered, it is unclear that there would be any increase in ‘trust’ as a result (a notion that seems to rest on a rose-tinted view of how the public actually views regulators and one that is in some tension with the findings on past regulatory performance) or that Ofgem has any comparative advantage in website design and operation. On the other hand, an Ofgem website that published information that is both salient to consumers and is not feasibly available on other websites would be a more interesting proposition. An example might be inter-area or inter-city comparisons of prices, in conjunction with information that might be relevant for assessing the causes of the differences. The availability of this type of relevant (to actual, not hypothetically deracinated, consumers) information could also affect suppliers’ conduct. A supplier might advertise that it was building business in a particular area/city and that consumers could see the benefits it was bringing by the changes in relevant inter-area/city prices.

<sup>3</sup> What an energy consumer ‘buys’ is, of course, more than just energy, billing and meter reading services being the most obvious other components of the bundle. Whilst the cost of providing these may be small in relation to energy costs, and while metering and billing costs may be relatively similar across suppliers, performance or quality of service differences among suppliers may be much more significant for consumers than these supply-side numbers might suggest. For example, billing mistakes can be a darn nuisance. A similar point applies to differences in tariff characteristics. Other things equal, some consumers might put significantly higher values on evergreen tariffs than others, not only because of the convenience of not having to shop around at regular intervals, but also because of perceived benefits of not having to think in advance about future contract renewal. Such preferences may explain why there is still a significant constituency for re-nationalization of supply, which extends well beyond those with an ideological commitment to socialism. The view that ‘things were easier then’ is not without merit. Competitive processes can, of course, cater for this demand by establishing financial incentives for suppliers to provide different types of consumers with what they want, including convenience and peace of mind for those who put a significant value on these things, whereas the application of constant pressure on all ‘disengaged’ consumers to ‘engage’ can come perilously close to a form of mandatory psychological exercise (PE), which will not be to the taste of many.

To illustrate, whilst keeping in mind the fact that markets are typically characterised by a mix of consumers with a range of levels of responsiveness (more specifically, different cross-elasticities of demand among the products and services on offer), suppose for explanatory purposes that consumers can be divided into two categories, less-price sensitive and more price sensitive, or Ls and Ms for short (the more accurate notion of a spectrum of price responsiveness can be re-imported, where necessary, by reference to degrees of “Lness” and “Mness”).

Standard economic textbooks explain how, in many (though not all) static contexts, Ls gain considerable benefits from the existence of Ms. The mechanism for this is the depressing effect of the presence of M’s on the aggregate consumer price-elasticity of demand for energy offered by a supplier on a given set of tariff conditions. Put another way, if there are Ms in the relevant consumer group, they are the people who most influence the aggregate price-elasticity of demand in the relevant price interval.

At a more advanced level of economics that encompasses dynamics as well as statics there can be found reasoning of the following type: *“For competition to work as a mechanism of recuperation from performance lapses it is generally best for a firm to have a mixture of alert and inert customers.”*<sup>4</sup> This can be compared with paragraph 40 of the Possible Remedies document: *“For liberalisation of retail energy markets to work effectively customers need to be adequately engaged”*. To be accurate, the words “some” or (better) “a sufficient number of” need to be inserted in front of the word “consumers”, *and that is a critically important qualifier*.

There is no basis for a *general* view that effective competition (competition that works well for the long-term interests of consumers) *requires* all, or even a preponderance of customers, to be Ms. It is better, therefore, that any such notion be explicitly set aside at the outset, so that analysis can get down to the real business at hand.

This would have the further benefit that it would not involve any fundamental challenge to the notion of consumer sovereignty. Consumers have limited resources – of money, time, cognitive effort – and even *homo economicus* may *choose not* to ‘engage’ (i.e. choose not to incur the costs involved in the relevant assessment exercises, involving shopping around, gathering information, assessing that information, and acting on it) in a particular market on the basis that the costs of so doing can be expected to be higher than the benefits. Choosing not to ‘engage’ with a particular market is a ubiquitous phenomenon: there is not time and cognitive capacity enough for across-all-markets shopping-around to be feasible, let alone desirable. Some reliance on habit or simplified rules-of-thumb or ‘inertness’ is transactionally efficient for each and every consumer, although the degree of reliance will vary from consumer to consumer.

---

<sup>4</sup> A. O. Hirschman, *Exit, Voice and Loyalty*. Another formulation of the same general idea (that a degree of inertia is favourable for dynamic incentives) is to be found in the notion of ‘shelters’ from competition. The RPI-X approach to price capping is another manifestation of the idea: inertia is deliberately inserted into the price review process to prevent regulators continuously resetting prices.

### ***The finding in relation to unilateral market power***

These points indicate that the follow-on conclusion in the Provisional Findings Reports – that “*the overarching feature of weak customer response gives suppliers a position of unilateral market power concerning their inactive customer base*” – would also benefit from some adjustment or development. The existence of *sub-groups* of consumers who exhibit low price responsiveness can only give rise to unilateral market power in combination with other things, not on its own, as theory and evidence indicate.

Incumbent market power has existed since the beginning of retail market liberalisation and has likely been on a downward path ever since (market concentration, for example, has fallen dramatically since liberalisation). Moreover, the early days were characterised by the existence of large numbers of consumers who could be labelled non-active, unresponsive, or disengaged. There were lots of Ls. The interests of these consumers appear to have been reasonably well protected in the earlier years of liberalisation, notwithstanding the significant unilateral market power that existed at the relevant time. This suggests, for example, that unilateral market power has not *by and of itself* been a cause of high net retail margins in general or, on a finer analysis, of high margins to SVT consumers in particular.

The issues with which the CMA is now grappling only start to manifest themselves in 2009, when the CMA’s data show the start of an upward movement in the EBITs of major suppliers.<sup>5</sup> For reasons discussed below (see in particular the remarks on the ‘rockets and feathers’ cycle), some upward movement in margins since 2008 is not *necessarily* problematic in itself – it *might* be a feature of reasonable counterfactuals – but it does provide clues about possible causal mechanisms. Perhaps the most perceptive of the relevant paragraphs in the Provisional Findings Summary is ¶187, which recognises that the nature of price competition is heavily influenced by rules that are determined by governance authorities (‘rules’ that include legislation as well as more specific rule-making by Ofgem) and it notes the sequence of regulatory interventions in retail energy markets that commenced with SLC 25A.

In the event that it is concluded by the CMA that the later EBITs were unduly elevated relative to a realistic counterfactual in which these regulatory interventions are assumed not to have occurred, the obvious interpretation of the data is that it was this rule change, *in combination with unilateral market power* (which, to repeat, was likely declining over time) that gave rise to any ‘overshoot’ in margins (relative to the assessed counterfactual). In short, the appropriate conclusion would be that the regulatory interventions served to leverage market power, arguably bringing what was a declining influence on the market back into active life.

---

<sup>5</sup> As an aside, the relative performance of individual suppliers is a potentially rich source of insights for competition assessments. For example, a classic indicator in testing for the exercise of collective market power is the profitability of the ‘marginal’ (least profitable) supplier. If this is super-normally high, there is more reason to think there is a problem. If not, a super-normally high industry level of profitability may reflect nothing more than the differential efficiencies of businesses operating in the market.

### ***Economic causation***

It is, I think, important to understand the causal mechanisms here in some detail, not least because the investigation has reached a point where further regulatory interventions are being contemplated. SLC 25A was the pivotal intervention. What it did was to prohibit a 'good' form of price discrimination, one that was both pro-competitive and served to protect the interests of less price responsive consumers. The price discrimination at issue was of a geographic, third-degree variety. This implied that discounted price offers were targeted at Ls and Ms alike, since all types of consumer are typically to be found in a given geographic area. The competitive pricing strategies in play were, as ¶187 notes, focused on SVTs. The activities of SVT Ms in a particular geographic area conferred benefits on SVT Ls in that area.

Post SLC 25A, and indeed slightly earlier in anticipation of the rule-change, the attention of suppliers became much more focused on non-standard offers, since these became the obvious way of competing with targeted discounts once geographic targeting had been prohibited. (This is a classic pattern: if competition is suppressed in one of its modalities, it tends to intensify in others.<sup>6</sup>) Price discrimination strategies shifted from a third-degree to a second-degree type. Whilst such tariff differentiation has benefits in terms of meeting differentiated consumer preferences, the regulatory distortion that caused it to acquire such central importance in the process of price competition among suppliers arguably brought some distinct disadvantages to Ls.

Second-degree price discrimination, unlike its third-degree cousin, functions as a sorting mechanism: it tends to attract Ms but not Ls to some tariffs, changing the mixes of Ls and Ms among tariff types. The obvious concern is that the loss of Ms from some tariff groups can reach a level where the benefits of their activities to Ls starts to become significantly eroded. In the current context, the fundamental question is whether or not the SVT category of consumers, or some narrower category still (such as SVT customers on standard payment terms), has become so denuded of Ms that harmful effects have eventuated.

It may be important to note at this point that this is not just a 'consumer protection' matter, deriving from a specific concern for the economic welfare of Ls. Going back to Hirschman's point, an imbalanced consumer mix is potentially an AEC since it can have adverse effects on competitive dynamics. More specifically, it can give poorly performing suppliers too long a period for recuperation. Consumers in aggregate may suffer longer-term harm as a consequence, not just Ls. Some care is therefore advisable before classifying particular issues as matters of 'consumer protection' rather than as matters of competition, particularly since it is longer term competitive dynamics that tend to be the main drivers of enhanced consumer welfare over time.

In the relevant factual context the potential problem of L-M sorting does not appear to be as large as the stark implications of simplified reasoning might suggest. The CMA's evidence indicates that there has been significant reversion of consumers from non-standard offers to

---

<sup>6</sup> The most common go-to examples are IPRs, such as patent protection which suppresses price competition precisely so as to increase competition in the development of new products.

SVTs, which may help explain why the SVT numbers remain as large as they are.<sup>7</sup> Moreover, at least some suppliers have said that their non-standard tariff decisions take account of an expected rate of reversion, which, in competitive conditions, implies that the prices on non-standard tariffs can be expected to be lower as a result (in the language that has been adopted, they are ‘acquisition tariffs’). Put another way, there is an element of ‘introductory offer’ to these tariffs. This fits the evidence presented by the CMA in that, in this familiar pricing pattern, price-cost margins are depressed at the introductory/acquisition stage – in some other markets to negative levels – and, *for the same consumer*, are elevated in later periods.

This pricing pattern, characterised by a wider spread between prices than between costs, is not itself an indicator of lack of competition, since it can arise naturally as a *consequence of competition* in a context where there are significant switching costs. In a sense the discounts ‘compensate’ switchers for the costs<sup>8</sup> they incur when they choose to move to a new product/service/tariff, but in a competitive market the ‘financial costs’ to the supplier of the ‘compensation’ will be in broad alignment with the later net revenues that accrue (customer acquisition being a form of investment). It is only significant imbalances between these (earlier) financial costs and (later) benefits that point clearly to a *competition* problem.

The pattern only exists, however, to the extent that some Ms, having enjoyed a period of lower prices, then revert to the SVT. When that happens the SVT segment is refreshed with an infusion of Ms, and the protection they afford to SVT Ls is enhanced. These reversions are therefore good for Ls. The sorting of consumers induced by second-degree price discrimination appears to be far from complete.<sup>9</sup>

On this basis, a key piece of information of relevance when assessing observed variations of prices and costs is the proportion of Ms in each tariff category, since this will give an indication of the level of business that will be most at risk for a supplier in the event of a unilateral price hike for customers in the tariff group.

This notion of the proportion of Ms in a particular tariff group is, of course, just a proxy for what is really of interest: the price-elasticity of demand facing the supplier for any tariff offering. As indicated above the immediate (but not the only) question is: has the tariff category been so depleted of Ms that this implies a material, downward effect on suppliers’ price-elasticities of demand? That is a rather different from asking: are all or most SVT customers ‘engaged’?

---

<sup>7</sup> I note, though, the steady decline in the numbers for SVT customers on standard payment terms, and it may be that more serious issues arise for this narrower consumer group.

<sup>8</sup> ‘Costs’ here are to be construed broadly in terms of things foregone, not just resource costs. Thus, if a particular customer has a sense of loyalty or affiliation to a particular supplier – for example, because the supplier has regional or national connections, supports favoured charities, is an employer of friends or family, has a CEO who is kind to animals, and so on – the ‘cost’ includes value of the attachments and affiliations foregone as a result of switching.

<sup>9</sup> But see footnote 7.

### ***The counterfactual***

Assessing the extent to which pre-existing, and likely declining, unilateral market power was possibly leveraged by the shift of competitive focus in retail energy market pricing strategies (stimulated by regulatory interventions) requires some appreciation of counterfactual possibilities. This is an extremely difficult exercise and the reluctance of the CMA to engage more actively with the issue is understandable on a straightforward cost-benefit analysis. Thus, looking at the evidence as a whole, I would concur with the CMA's judgment that a detailed counterfactual is not required safely to conclude that a sequence of regulatory interventions since 2008 has given rise to AECs. This, however, is only because the mechanisms by which measures such as SLC 25A and the four-tariff policy can be expected to restrict competition are so transparent and so easy to analyse<sup>10</sup> – as also are the effects of the abandonment of doorstep selling on switching rates (although in this last case the immediate effects don't translate so easily into propositions about competition). And it is notable that, even in the face of this transparency, the provisional findings are expressed in tentative ways.

Critically, however, there is a proportionality issue to consider at this point. More complex and/or subtle issues require rather more in the way of counterfactual analysis. If, for example, the CMA decides to maintain its interest in the possible safeguard tariff, price-capping remedy, significantly greater engagement with counterfactual issues cannot reasonably be avoided. Remedies need to be proportionate to problems identified and mandating the introduction of a new price-capped tariff would be a potentially draconian remedy<sup>11</sup> that could only be considered proportionate if the underlying problem is commensurately substantial. As well as clarifying the nature of the AECs to be addressed and the features that give rise to them, the economic significance of those features and AECs would require some calibration.

Since the evidence indicates that unilateral market power was not in and of itself a cause of recent, significant increases in retail margins, the usual simple argument for price controls based on constraining the exercise of substantial market power (the rationale for network controls) is a weak one in the relevant context. The question quickly becomes: how might things be expected to develop if the remedy is implemented relative to how things might be expected to develop if it isn't? In seeking answers, it is immediately apparent that it would be illegitimate to proceed on a *ceteris paribus* assumption. Just as SLC 25A perturbed suppliers' pricing strategies more generally, so would the introduction of a price-capped safeguard tariff.

The CMA's reluctance to engage with the counterfactual issues raised by past regulatory interventions would at this point become a real weakness. If counterfactual questions

---

<sup>10</sup> If there were any analogue in market investigations of the 'by object' provisions of Article 101 TFEU, it might be said that the measures would fall into that box.

<sup>11</sup> Large numbers of customers could opt for the safeguard tariff, given its convenience and particularly if that convenience is offered to them at a favourable price, possibly influenced by political pressures to keep it low. In that case, it could become the dominant tariff in the market and the effects could begin to approximate those of comprehensive price control of retail markets.

about past regulatory measures were judged to be too difficult to answer, there is little reason to think that similar questions about the future can be answered with anything more than speculative guesses. Moreover, whereas more precise answers about the effects of past regulatory measures can reasonably be regarded as optional, because the major issues were relatively simple in those cases, they are I think a necessity when it comes to evaluating a proposed measure that can be expected to have more complex, future effects. It is for good reason that regulators are required to engage in often extensive consultation exercises when considering whether or not to introduce such measures.

### ***A price-cap remedy?***

In relation to the potential remedy of re-introducing a price cap, my general advice to CMA and Ofgem alike is to follow Healey's Law: when in a hole stop digging. The evidence points to capricious regulation, which sought to substitute administrative determinations (on relative prices, on number of tariffs) for market determinations, as a causal factor in creating AECs, and a price-cap would be more of the same.

If the CMA Panel believes that it has not yet been able to come up with remedies that meet the statutory requirements – and that would be an understandable position in view of the complexities of the challenges – a better course would be to take more time on the matter (as I suggested at the outset might be advisable), determine those of the remedies that constitute the low-hanging fruit, and set out, with the specificity that is feasible, some clear guidance and principles for the regulation and governance of retail energy markets going forward.

### ***Drawbacks of price-caps***

Given the submission of the FRs and since it can be expected that the CMA will be not be short of other submissions pointing out the various pitfalls of imposing price-caps on retail energy markets, the specific comments to be made here need only be limited in scope, focusing on points that might not be given centre stage in other submissions.

First, if the weight of informed economic opinion is heavily against the idea, as I think it will be, it is to be hoped that the CMA will pay more attention to those views than did GEMA when introducing SLC 25A.

Second, it would be wrong to take much comfort from the notion that a cap would only be temporary. This is less because of the risk that it would become permanent – the risk of that is probably low – but more because, like with SLC 25A, the evolution of the market and the development of regulation will be more generally affected and its adverse effects would not simply disappear once the formal cap had been withdrawn. The fact that a measure is temporary does not imply that its effects will be temporary.

Third, for the period of its existence, a cap would introduce a very major focal point into the market. It would be a focal point not just for suppliers setting prices, but for politicians and the media too. This is Energy. The effects are largely unpredictable, but on balance are they likely to be malign. The unpredictability would itself be damaging to regulatory certainty and, in the end, that may be the most important of all the issues.

Fifth, price capping is not exactly in line with best practice in other jurisdictions, or with EU policy, or with current UK government policy, all of which are, perhaps unusually, in broad alignment at the current time.

Sixth, as indicated earlier a good deal more work would need to be done, particularly in relation to counterfactual evaluation, to ensure compatibility with EU Directives. The exercise that could easily end in failure and could draw resources from more productive activities of the responsible body.

Seventh, the remedy would be damaging to the functioning and reputation of the body chosen to implement it, whether that is Ofgem or the CMA. If Ofgem was designated, it would amount to throwing the regulator into a bear-pit – or, if an alternative metaphor is preferred, to throwing the regulator a hospital pass – when what would be much more helpful would be to guide Ofgem toward compliance with Healey’s Law. Among other things: it would be hard to get through the temporary period of the cap without Ofgem suffering more permanent reputational damage, internationally as well as locally (which matters because Ofgem’s international influence has generally been globally beneficial, even in bad times); limited regulatory resources would be diverted from implementation of other CMA remedies, including developing code governance arrangements and sorting out some of the obvious problems in the micro-business segment (both major tasks); and there must be some risk of getting bogged down in appeals against decisions, particularly given the proportionality requirements of the EU Directives and given that price determinations would inevitably contain a large slice of arbitrariness (see below).

Given this last point, if the CMA were to proceed it seems to me that the appropriate implementation body would be the CMA itself. As stated, the intervention would be out of line with long maintained Ofgem policy – sustained even through the 2008-13 wobble – and does not fit easily with EU policy or norms of best-practice regulation in the sector. If this is what the CMA wishes to do, it should properly bear the costs and reputational risks itself and be explicitly accountable for the outcomes. However, as should be clear from the above, I also think that it would be unwise for the CMA to inflict these costs and risks on itself by jumping into the hole and digging deeper.

### ***The arbitrariness and proportionality problems***

The business of producing price controls is the ‘pork pie factory’ of economic life. While there is a steady demand for the output, those who work or who have worked in the factory tend not themselves to be noticeably keen on the product: they know too well how it is made. The CMA’s own analyses and the questions raised in the Notice of possible remedies provide some glimpses of the inside of the factory.

One candidate approach that might sound attractive in theory is to strive to add a headroom allowance to the competitive price of the capped tariff(s). Unfortunately the competitive price is not something that can be known with any great accuracy *ex ante*, since by and of its nature it is something that can only be discovered by observing, *ex post*, the outcome of a competitive process. What, in effect, the approach asks for is a *forecast* of a variable that is determined by a vast set of market information, the great bulk of which is

unknowable to any single economic agent. Particularly for a temporary price cap, there can be no recourse to notions of a long-run level of competitive price: what is required is a forecast of the competitive prices that could be expected to pertain *over the short-period in which the cap would be in existence*. Additionally, the forecasting process would be constrained by the procedural requirements with which a public authority exercising substantial market power must properly comply.

An alternative would be to build up the allowable price from costs, which is the traditional regulatory approach for network regulation, and then add a headroom allowance. The CMA has attempted a cost assessment in its own accounting exercises, but retail energy markets are not monopolised and there are multiple difficulties, of which the following are only examples.

Costs include capital costs, which depend on the cost of capital and the capital base (capital employed). Energy retailing is, however, a business that is light on tangible assets. Estimates of intangibles are therefore required. As the CMA document recognises this requires, among other things, an evaluation of customer acquisition costs: money spent on marketing to acquire customers is a form of capital investment and, as already explained, so are price discounts aimed at attracting customers who will generate higher net income in the future. To see the difficulties simply consider the question: when a supplier offers a discounted price via a non-standard-tariff to acquire a customer, how much of that discount is to be counted as investment and capitalised? The question has no obvious answer, and it invites the making of arbitrary assumptions to produce a number.

There is no escape from the capital estimation difficulties by way of assumptions that major energy retailers inherited their customer bases, that customer acquisition costs can therefore be assumed to be modest, and that any errors are therefore likely to be small in magnitude. That does not fit the facts. Centrica started as a gas-only supplier, so every electricity customer has necessarily been acquired in some way or other. The other suppliers have their roots in electricity-only companies, so every gas customer has necessarily been acquired. The numbers can be expected to be large.

The exercise also requires starting the clock at the time of market-opening, covering years in which the requisite data will almost certainly not be available. Immediate questions include: Should the implementing body therefore make a best guess? Should it include as investment the out-of-area discounts that were declared 'unfair' in 2008 and prohibited in 2009? Would an appeal body likely uphold those guesses?

In times past the MMC often set aside ROCE assessment for businesses that were light on tangible assets and instead had recourse to benchmarking on the basis of comparative margins on sales. That is a possibility, but it would involve international comparisons which bring their own difficulties. Good comparators are very hard to come by and the one that I know best, the State of Victoria in Australia (a significantly better comparator for GB than New South Wales), might well exhibit *higher* retail margins than are currently observed in GB. If headroom is then to be added, should the implementing body go ahead and set what

might be a quite high price, discounting the risks that this might introduce a focal point that would facilitate the setting of prices higher than would otherwise be likely?

In this type of exercise there also tends to be a form of confirmation bias characterised by choosing, from the long list of possible assumptions that can be made, a set of assumptions that leads to the kind of number that is thought might be appropriate at the very outset. This tendency is arguably observable in the CC's Small Business Banking investigation (2002), in which the Panel declined to accept the argument that profitability should properly be measured over a full business cycle. Among many other assumptions relied upon to arrive at the CC's ROCE estimates were that: banks' credit risk and management processes had improved significantly since the early 1990s; there would be no repeat of the housing price downturn of the earlier period; and there would be no repeat of the 'unwise' decisions of banks in the earlier period.

Those assumptions looked data-consistent for a while, but their speculative nature became transparent from 2008 onwards. Moreover, the latest Basel proposals for capital allocation suggest a much higher risk weighting for small business banking than was considered appropriate at the turn of the millennium, implying that, if the very same exercise were to be repeated, using the same data as the CC used but adopting the proposed new procedures, the calculated ROCEs now would be significantly lower than they were then. The data have not changed, but their translation into capital employed and ROCE numbers would change substantially.

Recollection of the small banking investigation gives rise to a sense of *déjà vu* about the profitability assessment exercises undertaken in this investigation. Profitability is assessed over a relatively short period, not over a full cycle, and is compared with a long-run cost-of-capital estimate that itself is subject to volatility over time (e.g. the network price controls across sectors that were determined prior to the financial crunch systematically estimated costs of capital that rapidly came to be substantially out of line with market rates).

In relation to the choice of period, it is not uncommon in markets that rely on a major input that is subject to price volatility – here wholesale electricity and gas – (i) for there to be lags between cost increases and price responses and (ii) for the lagged responses to exhibit a 'rockets and feathers' pattern whereby the price movements are sharper on the way up than they are on the way down (an 'escarpment pattern'). In competitive conditions the price movements following an upward price shock usually imply accounting rates of return on capital that are below normal in the early phase and above normal in the later phase. The most appropriate way to proceed in circumstances characterised by major input price shocks is therefore to look at rates of return over a period long enough to allow all stages of the response pattern to be assessed.

Wholesale energy costs started to rise strongly around 2005 and by starting the calculations at 2009 the CMA accounting exercise fails to take account of years in which rates of return might be expected to be low and takes account only of data in periods when rates of return might be expected to be higher. As in the small business banking investigation, the

discounting of manifestly relevant information has the effect of biasing the estimates upwards.

An indication that this is a problem lies in the claim that excess profits averaged approaching £900m per annum in the period from 2009 onwards. *Prima facie*, as noted in the FRs' submission on these matters, a comparison with the EBIT data suggests that any EBIT above zero would constitute excess profits, which is a strange result. Extension of the calculations back to include, say, the three years prior to the years assessed would likely yield a very different average ROCE, a fact that is of high salience when examining the case for price control, particularly in relation to proportionality and causality/targeting issues.

### ***Final thoughts***

The CMA's final report will, I believe, be a landmark document because, much more clearly than in any comparable exercise to date, it seems that it will recognise that market governance arrangements are, in practice, a major potential source of AECs (a recognition that suggests that some adjustment of the list of 'sources' in the Guidelines for market investigations would be advisable). At this stage, however, the drafting of the summary provisional findings still exhibits a propensity for obscurity.<sup>12</sup>

Good governance is capable of creating a higher trust, lower transactions cost environment in which market participants can go about their buying and selling with reasonable confidence, for example by establishing and enforcing market rules that are stable, not in the sense of being set in aspic – because changing circumstances will dictate adjustments – but that that are contingently predictable, i.e. for any given change in background circumstances, market participants can form reasonable expectations of how the market rules will likely evolve in response.

Such predictability has been seriously degraded over the recent past and my own view is that this is the single most important explanatory factor for the observations set out and examined in the CMA documents.<sup>13</sup> SLC 25A is of particular importance for what it signified – a sectoral regulator whose actions in relation to retail energy markets (but not to networks) had become detached from the principled pursuit of stable objectives, and hence whose behaviour lacked contingent predictability, including to itself. If that is right, the

---

<sup>12</sup> Ofgem takes many decisions, and it would amount to non-administrable regulation to require it *only* to take decisions that have the effect of promoting competition. Thus, to say, as in paragraph 198 of the summary provisional findings, that the decision to prohibit price discrimination did not promote effective competition is true, but it is economical with the truth. If that had been the only thing 'wrong' with the decision, it would have been unobjectionable. The point is that it could be expected to give rise to AECs. Why not call a spade a spade? The unnecessarily tortuous language in the paragraph also gives rise to a misleading conjunction of the decisions on price discrimination and on locational losses. It is also true to say that the decision not to approve the charging of locational losses did not promote competition, but in this case it is an open question as to whether the decision gave rise to AECs. There is a plausible line of reasoning to the effect that some geographical flattening of transmission charges, relative to a SRMC outcome of the sort that occurs with comprehensive nodal pricing, is positive for competition among electricity generators, and there is already substantial locational differentiation in the TNUoS component of transmission charges. The stronger argument for locational losses is based on the potential for reducing short-run energy costs, not on the likely effects on competition. The economic trade-offs surrounding the two decisions are quite different.

<sup>13</sup> It is appropriate at this point to acknowledge that the conduct of environmental policies, which is not covered in this submission, has been a very significant factor in increasing regulatory uncertainty.

principal benefit that can potentially come from the CMA's work is to increase regulatory certainty, implying that this should be a principal criterion to be used when assessing remedies.

Regulatory uncertainty is adverse for investment in general, and in retail markets the principal investment of suppliers is in the customer base. There is an obvious tension/trade-off for a well-established supplier between pricing lower to build or defend a customer base and pricing higher to extract higher returns from the existing customer base. Capricious regulation that creates avoidable uncertainty tends to tilt the balance toward the latter, exploitative strategies and that shift is, I think, what happened circa 2008/9, exacerbated by specific features of new rules that positively restricted the ability of suppliers to engage in some types of 'investment practices' (out-of-area discounts, tariff innovation).

On this basis, price capping would likely be another violation of Healey's law: it would increase regulatory uncertainty, not reduce it.