

# The CMA should not cap energy retail prices



The UK Competition and Markets Authority (CMA), following its provisional findings in relation to its energy market investigation, has proposed various remedies to help address the causes and, importantly, the outcomes associated with the lack of competition. This Insight argues that the CMA should not pursue either remedy at this time.

## Background

On 7 July, the CMA provisionally found that competition works well in many parts of the UK energy market (of course subject to some important caveats) including in electricity generation and wholesale gas and electricity markets. However, the CMA has also found that competition is not working well in retail markets and has proposed various remedies to help address the causes and, importantly, the outcomes associated with the lack of competition.

In this insight we focus on two of the more far reaching remedy proposals: “Ofgem [the economic regulator for energy in the UK] to provide an independent price comparison service

<sup>1</sup> See CMA (7 July 2015), “Energy Market Investigation – Summary of provisional findings report.”

<sup>2</sup> *Ibid*, paragraph 131.

for domestic (and microbusiness) customers” to and “A transitional ‘safeguard regulated tariff’ for disengaged domestic and microbusiness customers”. We argue that the CMA should not pursue either remedy at this time.

## Overview of the CMA’s findings

The CMA has identified two main reasons for the lack of competition in retail markets: lack of customer engagement and regulations introduced by Ofgem.<sup>1</sup>

### Lack of customer engagement

In relation to the lack of customer engagement, the CMA makes two main observations:

- » **The rate of switching by some customers is low.** It finds that between 20 and 30% of electricity customers of the Six Large Energy Firms have been with their current supplier for more than ten years – the range is between 10 and 40% of domestic gas customers.<sup>2</sup>
- » **A large number of customers could make significant savings by switching, but they do not.** For example, the CMA finds that 70% of the customers of the Six Large Energy Firms (...) are on a Standard Variable Tariff (SVT). An SVT is the tariff customers pay if they do not make an active decision to change tariff – either by switching to a non-standard tariff offered by their existing supplier or another supplier. Customers on SVTs pay around 10 to 13% more than customers on a non-standard tariff for electricity and gas respectively.<sup>3</sup>

The CMA attributes the lack of customer engagement to various factors, including that in its view:

- first, there is no quality differentiation of gas and electricity (the same core product is supplied, irrespective of supplier), reducing customers’ enthusiasm for engaging with the market;<sup>4</sup>
- second, customers have little awareness of how much gas and electricity they consume and when they consume it;<sup>5</sup> and

<sup>3</sup> *Ibid*, paragraph 91.

<sup>4</sup> *Ibid*, paragraph 123.

<sup>5</sup> *Ibid*, paragraph 123.

- third, customers can find it difficult to access information on the alternative tariffs available and some do not trust price comparison websites (PCWs).<sup>6</sup>

## Regulations introduced by Ofgem

Ofgem is the economic regulator for energy in the UK. In 2010, Ofgem launched its “Retail Market Review” and afterwards implemented various reforms intended to increase customer engagement. One of the reforms was to limit the number of tariffs that retailers can offer to four. The idea was that this would make it easier for customers to compare tariffs and therefore increase their ability and willingness to search and switch.

Based on the evidence so far, the CMA has found that customer engagement has not increased since the reforms. Further, the CMA has found that the reforms may have made matters worse: suppliers have withdrawn some more innovative tariffs; removed discounts; and limited their ability to offer attractive tariffs for low volume customers. The CMA is also concerned that, as smart meters are rolled out, limiting the number of tariffs that retailers can offer in this way will stifle innovation.<sup>7</sup>

According to the CMA, another consequence of limiting the number of tariffs that suppliers can offer to four, is that it limits the competition between PCWs because they can no longer secure exclusive tariffs from retailers.<sup>8</sup>

The CMA cites other regulations – such as a prohibition on regional price discrimination – that may also have reduced competition or could do so in the future.<sup>9</sup>

## Overview of the Ofgem price comparison service and safeguard regulated tariff remedies

The CMA has proposed a number of remedies to help address the lack of competition in retail markets.<sup>10</sup> As noted above, two of them would involve: Ofgem providing an independent price comparison service for domestic (and microbusiness) customers; and the CMA or Ofgem introducing a transitional safeguard tariff for disengaged domestic and microbusiness customers.

### The Ofgem price comparison service remedy

Here, Ofgem would “*operate an independent price comparison service with whole-of-market coverage*”. The CMA’s motivation for suggesting this remedy is PCWs can help customers search and switch to tariffs that are right for them. But they are not used enough in the CMA’s view and it thinks that this is, in part, because they are not trusted by some customers. The CMA believes that this remedy would help

<sup>6</sup> Ibid, paragraph 125.

<sup>7</sup> Ibid, paragraph 142.

<sup>8</sup> Ibid, paragraph 145.

<sup>9</sup> Ibid, paragraph 147 et seq.

<sup>10</sup> See CMA (7 July 2015), “Energy Market Investigation – Notice of possible remedies”.

increase trust in PCWs by allowing customers to check tariffs they have been quoted by PCWs with Ofgem’s independent service.<sup>11</sup>

### The transitional safeguard tariff remedy

The CMA’s motivation for suggesting this remedy is to protect those customers that do not respond to its remedies designed to address the lack of customer engagement (including but not limited to measures to prompt customers on SVTs to engage in the market). Customers that do not respond to such remedies and who would therefore remain or be rolled onto an expensive SVT would instead be rolled onto the safeguard tariff. The safeguard tariff would have a maximum price set by either the CMA or Ofgem. The maximum price would be set low enough to offer such customers protection, but not so low as to deter suppliers from trying to compete for their business.<sup>12</sup>

### The Ofgem price comparison service...how strong is the evidence for the market failure?

At this stage, it is not entirely clear what the difference between an Ofgem price comparison service and typical PCW would be in practice. One possibility is that the Ofgem price comparison service would be limited to providing price comparison information, whereas a typical PCW also allows customers to switch tariffs.

What is clear, however, is that this remedy involves the public sector undertaking some activities that are already undertaken by the private sector. This raises the possibility that the public sector could inefficiently ‘crowd out’ the private sector – contrary to the CMA’s objectives in proposing this remedy – or distort competition in some other way.

Therefore, to pursue such an intervention, one would have to be very confident that: (a) there is a market failure in the supply of PCWs; and (b) that the best way to remedy it involves public sector provision of some or all of the relevant service. These hurdles are, rightly, high.

The market failure that the CMA points to is a lack of trust in the services offered by PCWs. This view is based on its customer survey.<sup>13</sup> But the customer survey paints a rather more optimistic picture of the use of PCWs than is implied by the remedy proposal.

» The CMA has also found that the use of PCWs in the energy markets is at a similar level to that in other markets.

» Over 3 in 5 of those respondents that had switched in the last three years used a PCW to search for a new tariff and around half of those made the switch via a PCW.<sup>14</sup>

<sup>11</sup> Ibid, paragraph 66 et seq.

<sup>12</sup> Ibid, paragraph 91 et seq.

<sup>13</sup> CMA (7 July 2015), “Appendix 8.1 – CMA domestic customer survey results.”

<sup>14</sup> Ibid, paragraph 41.

» 55% of all respondents said that they were confident using PCWs, 27% were not confident using PCWs and 17% did not have internet access.<sup>15</sup>

» Of the 27% that were not confident<sup>16</sup>:

- 43% said they did not trust or believe the PCWs.
- 26% found that the information was too complex.
- 16% had never used a PCW and would not know what to do.<sup>17</sup>

So, out of all respondents to the CMA's survey, only around 12% (27% x 43%) said that they did not trust or believe the PCWs. This does not seem to provide very compelling starting point to recommend such a remedy. Would the potential benefit to around 12% of respondents offset the potential costs and risks associated with introducing an Ofgem price comparison service?

Relatedly, the extent to which the customer survey paints a sufficiently complete or accurate picture of customer attitudes towards PCWs for the purpose of remedy design is not clear. In terms of:

- **Completeness**, the survey does not reveal what precisely it is about PCWs that respondents do not trust.
- **Accuracy**, it seems possible that, at least for some respondents, the explanation of a lack of confidence arising from a lack of trust is not the full story.

In short, the evidence presented by the CMA is not suggestive of a material market failure in the supply of PCWs – the first hurdle above. Moreover, it is not clear exactly what the 'trust' problem is and therefore whether an Ofgem price comparison service remedy would address it – the second hurdle above.

The CMA should not pursue this remedy until it has cleared these hurdles and it has not yet.

## The safeguard regulated tariff...will it further reduce customer engagement?

Transitional safeguard regulated tariffs were used in the UK energy market when it was being liberalised. They were gradually withdrawn when the then economic regulators were comfortable that competition provided sufficient protection to customers.

As noted above, in proposing this remedy, the CMA rightly observes that: "...there are always risks associated with controlling outcomes in markets, and in exploring these options we will need to be sufficiently confident that such a remedy would not unnecessarily cut across the beneficial effects that competition has the potential to bring customers..."<sup>18</sup>

<sup>15</sup> Ibid, paragraph 42.

<sup>16</sup> Ibid, paragraph 43.

<sup>17</sup> It is not reported what the other 15% think.

<sup>18</sup> Notice of possible remedies, paragraph 91.

The CMA then goes on to suggest that avoiding such "cut across" depends on getting the price of safeguard regulated tariffs right: "*The level at which a safeguard cap is set has important implications. If it is set tightly, it will have a damaging impact on competition, undermining incentives to engage in the markets. On the other hand, if it is set a too high a level, then at best it will provide no protection for customers, and at worst potentially provide a higher focal point for default prices to settle.*"<sup>19</sup>

This is clearly an issue, but it is not the only one. In a recent article we argued that the existence of safeguard regulated tariffs could themselves delay the development of competition for three other reasons.<sup>20</sup>

- » First, the existence of a safeguard tariff could reduce customer engagement in the market by reducing the perceived benefit of searching for a new tariff.
- » Second, the implementation of a safeguard tariff could reduce customer engagement in the market by eliminating a trigger for search behaviour.
- » Finally, on the supply-side, incumbent suppliers may be hesitant to reach out to customers and offer more competitive tariffs as those tariffs do not have the explicit 'regulatory permission' that they have become used to – potentially further reducing customers' appetite for shopping around.

For these reasons, even if the price of a safeguard regulated tariffs are set 'correctly' (and this by no means straightforward and will come under significant stakeholder and political scrutiny), their existence and implementation could still have a detrimental effect on competition.

For these reasons, the circumstances under which such an intervention makes sense are very limited indeed.

The CMA should not pursue this remedy now. It would be better to see whether its other remedies designed to address the lack of customer engagement have their desired effects first.

## Conclusion

The CMA is due to publish its final report in April next year. There is no doubt that it will implement remedies designed to encourage customers to engage with the market and many of them make sense. But the Ofgem price comparison service and the safeguard regulated tariff proposals should fall off of its list for now, unless it finds very compelling evidence for them in the meantime.

*Economic Insight advises economic regulators and firms on competition issues.*

<sup>19</sup> Ibid, paragraph 93.

<sup>20</sup> Harvey, J. (2015), "How to protect consumers while competition develops", ECLR Volume 36, Issue 3.

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