# Ofgem: Consultation on a proposal to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain

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## Consultation response from the ESRC Centre for Competition Policy


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The response to each question in this consultation response has been drafted by a named academic member of the Centre, who retains responsibility for that section. The document has the broad agreement of the group of contributors.


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While the political argument for a referral may be compelling, many of the economic arguments are not. In particular the features identified in the document might well be assessed differently if applied to a different industry.

In assessing the economic arguments especially as they relate to consumer behaviour, it is often hard to see from the consultation document what benchmark model of the market Ofgem has in mind.[1] Helpfully, the accompanying "State of the Market Assessment" [SMA] at paragraph 3.1, contains the following statement taken from the Market Investigation Guidelines of the Competition Commission together with Ofgem's assessment on how that translates into the energy market:

> "For competition to work effectively, suppliers must feel a threat from consumers switching to a competitor's product should there be better offers in the market. Therefore, for the energy market to work well, we need a sufficient number of engaged consumers, able to assess, access, and act on information."

One could not argue with that as a necessary condition for a market to work and we will take this as a starting point.

## Enough firms for competition?

An important element of the quote is that there are suppliers, plural. In the household energy market there are six large firms and a substantial number of, to date, very small entrants.

- "Whilst there have been some changes to the market shares of the six largest players, the structure of the market remains relatively stable and there has been no major disruptive entrant since market opening." [5.7] [2]

  The changes in the quote refer to the period 2008 until now. Is this really a smoking gun? Firstly, stable market shares are not evidence of anything other than the market being in equilibrium. Secondly, why do we think that six firms is not enough for competition? Imagine an industry with a proposed merger from 7 to 6 where market shares had been stable for some time and where there had been no major entrant. Would we expect that such a proposed merger would be referred to a phase two investigation?

- "The relatively stable market shares of the six largest suppliers over time and the fact that EDF as the only 'long' supplier is currently offering the cheapest tariffs as a means to grow its retail business provides further evidence to support this hypothesis." [3.24 - the hypothesis refers to weak competition among existing suppliers].

  First of all, stable market shares on their own are not evidence of lack of competition. More worrying is the assertion that observing the firm with excess supply offering the lowest price is evidence that the market is not working. Consider low-cost airlines – when a firm in this market has excess capacity, it reduces its price. Why is this not a text-book example of how markets work rather than one of how they do not work? Secondly, if EDF is successful in growing its retail business, how can it do so without shifts in market shares?

The argument that six firms is not enough for competition appears to rest on a concern that firms may be colluding tacitly. Given the difficulty of sustaining collusion without any evidence of an

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[1] For an attempt to identify what would constitute a "well-functioning" market in energy, see: Hviid, M. and C. Waddams, 2014, "Well-functioning markets in retail energy", European Competition Journal 10(1), 167-179.
[2] The bullet points refer to direct quotes from the consultation document with our comments to follow.

agreement, we would expect there to be some facilitating practices (plus factors). If so, what are they? Firms need transparency to monitor each other and know where to pitch (tacitly collusive) prices. The non-discrimination clauses introduced by the regulator are a good example of the sort of facilitating practice which firms themselves might have adopted through a Most Favoured Nation clause, had they thought it would be acceptable to the regulator. As predicted[3], this regulatory intervention reduced competition[4], and the focus of the Retail Market Review on increasing simplicity and transparency may have similar effects.

Moreover, since tacit collusion is not illegal – firms can only be compelled to compete by market forces – what would be the remedy? If the CMA cannot identify crucial plus factors, the only remedy would be creating more firms. If six firms are not enough for tacit collusion to break down, how high do we have to go?

## The role of consumers

The other part of the statement from the SMA document is that enough consumers have to play their part in making markets work well. The consultation document does not set out a measure of when there are "enough" active consumers, something one could not criticise them for since this is still one of the great unknowns, and not just as regards energy. The concerns raised in the consultation document relate more to evidence that consumers are not active enough. We have picked out and commented on some of the statements below:

- "In competitive markets we would expect to see consumer actions, such as the threat of switching supplier, exert competitive pressure on suppliers." [paragraph 3.6 in consultation document].

  Note that this is very different from paragraph 3.1 in the SMA quoted above and on its own this statement is simply false. A firm's fear that consumers may switch if they are more expensive than rivals may well motivate its price setting, but inactivity by consumers is not in itself evidence that a market is not functioning. Indeed it could be evidence that it is functioning well.

- "As Ofgem has previously observed, energy as a product has low intrinsic interest for consumers - it is consumed indirectly through the provision of heat, light, cooking etc." [3.7]

  This would appear to suggest that goods and services consumers consume indirectly is of no interest to them. What if instead of energy the product was for example olive oil which arguable is also consumed indirectly in salads, cooking etc?

- "The Assessment considers the switching rate to be an indicator of the extent of competition in a market." [3.12]

  More precisely the claim by Ofgem is that low or no switching implies a problem. This may be so, but then this level of active competition is associated with dis-equilibrium rather than equilibrium. In a competitive market equilibrium with identical prices for identical goods, we would obviously see no switching but equally we would not classify such a market as a problem market.

- "Stakeholders said that the low levels of consumer engagement and ability of larger suppliers to target cheaper tariffs towards the most active consumers in the market (as described below) make it more difficult for small suppliers to win market share." [3.28]

[3] Morten Hviid and Catherine Waddams Price, 2012, "Non-discrimination clauses in the retail energy sector", The Economic Journal, 122 (August), F236–F252.

[4] Catherine Waddams Price and Minyan Zhu, 2013, "Pricing in the UK retail energy market, 2005 – 2013", Centre for Competition Policy Working Paper 13-11

Any firm targeting those consumers who were active would obviously prefer there not to be competition for those active consumers, so the concern raised is obvious but should not carry much weight.  Since it is not possible to have competition for the inactive consumers, is this not the competition we want to encourage?  If we do not let active consumers benefit from their activity by leaving them with more surplus than if they had remained inactive, why should they bother?  If inactive consumers are promised the same benefits from competition as those who spend effort to make competition happen, why would they stay engaged?

- "we have found that suppliers can exercise market power over their incumbent customers" [3.36]

  In any market where consumers have a deep loyalty to their current supplier, that supplier would have market power over them.  What is special about energy?  Some people pay the ticket price for branded goods while others wait for the sale – is the market power yielded over the fashion conscious problematic and should this also be investigated?

Lack of trust is mentioned numerous times in the document – but the "so what?" question is never tackled, nor is there any clarity about what this trust relates to.  There must be many markets where we do not "trust" the suppliers to do anything other than look out for themselves – business should not be confused with philanthropy, nor should consumers be encouraged to step away from the "caveat emptor" attitude to offers.

- "A total of 43 per cent of domestic customers surveyed did not trust suppliers to be open and transparent with them in 2013, compared to 39 per cent in the previous year." [3.42]

  Is the increase from 39% to 43% statistically significant and to what extent is this different from other markets?  What does this mean and what consequences flow from it? Is the argument that it is the lack of trust which makes consumers inactive?  Figure 14 in the SMA does not appear to support this conclusion.

## Politics not economics

- "A consistent reason for not entering the market was the political environment surrounding the energy market and the uncertainties surrounding the future of policy." [3.30]

We are repeatedly told that consumers are not interested in the energy market.  This leads to something of a puzzle. If consumers are genuinely not interested, why have politicians from all the major parties become so excited and intervention-happy in this market?  All the major parties propose substantial intervention in the energy market, and none has proposed sensible policies.

Our main concern is that the consultation document does not clearly state why energy is different, leaving the potential for a conclusion that the referral is a political decision rather than one taken on the basis of competition concerns and economic and legal analysis.  If the main issue is political, it is hard to see what the CMA could do.

The referral would only have a positive outcome if the market is allowed to work. Trust ***is*** important, and needs to extend to politicians trusting the framework and decisions of the CMA if a more competitive industry is to result.