

# Business, Energy and Industrial Strategy Committee: Pre-legislative scrutiny of the draft Domestic Gas and Electricity (Tariff Cap) Bill inquiry

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Consultation response from the

## Centre for Competition Policy

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This consultation response has been drafted by the named academic members of the Centre, who retain responsibility for its content.

### The Centre for Competition Policy (CCP)

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### Executive Summary

- ✦ Since the CMA decided against a broad tariff cap, and since there are likely to be losers as well as winners from such an intervention, the decision to implement a cap is a political decision and it is appropriate for this to require legislation.
- ✦ Competition is a process and the 'conditions for effective competition' are hard to define.
- ✦ There is no guarantee that the 'conditions for effective competition' will exist by 2023. There are helpful measures in development. However, CCP research shows that while well-designed demand-side remedies can be valuable, they are unlikely to resolve all competition concerns in markets where firms can discriminate between engaged and unengaged customers.
- ✦ There is a fundamental trade-off between the extent of protection offered by a cap and the extent of its (harmful) impact on the competitive process.
- ✦ Given the downside risks, we suggest the Ofgem review process explicitly evaluates the extent of any negative competitive impacts resulting from the cap and this criterion is explicitly included in the Secretary of State (SoS)'s decision to renew the cap.
- ✦ It is clear that matters (a) to (e) in clause 1(6) cannot all be satisfied to their full extent simultaneously: there are inevitable trade-offs between them.
- ✦ CCP research predicts that the rate of switching will fall following the introduction of a cap (all else being equal), but the switching rate itself should not be the main measure of success.
- ✦ There is a clear risk the price cap has a significant negative impact on the competitive process and on particular groups of consumers.
- ✦ The role of the SoS in the final decision on the continuation of the cap means it is more likely the cap will remain in place.
- ✦ Where the SoS deviates from the conclusions of Ofgem's review, the SoS should be required to publish reasoning justifying the deviation.
- ✦ We are against a 'basic' relative cap; CCP research into regional non-discrimination clauses highlights the downsides of poorly designed tariff caps/restrictions.
- ✦ We highlight alternative options for designing the cap, but do not recommend a particular approach other than that the cap must be robust to manipulation by firms
- ✦ One long-term alternative to a cap would be to hold opt-out collective switches where the price paid by inactive consumers is determined in an auction. The auction creates the pricing pressure which inactive consumers are unable to generate themselves.
- ✦ A cap will not remove firms' existing knowledge regarding which consumers are active and inactive; the incentive to charge a higher price to inactive consumers will remain.

We welcome the opportunity to respond to the Select Committee's inquiry on the draft tariff cap legislation. We respond to each of the questions raised on the Committee's webpage in turn.

### Objective of legislation

#### **1. The Government's stated objective is "protecting customers until the conditions for effective competition in this market are in place". Is this a clear objective?**

Defining what constitutes "the conditions for effective competition" in the energy market has been, and is likely to continue to be, problematic. Competition is a (sometimes bumpy) process, and one of the advantages of markets, as compared with regulation, is they allow for evolution towards outcomes that were not previously envisaged. This means what constitutes "effective competition" and what "conditions" are required for this to occur is inherently uncertain and may change through time.

Moreover, the process of competition, even when considered effective, may generate outcomes that are unpopular with the public and do not meet with the expectations or desires of politicians or policymakers. For example, it is well understood that price discrimination can emerge even in highly competitive markets. Indeed, this can be an efficient form of pricing, as it can widen market access while allowing firms to cover their fixed costs; "yield management" ticket pricing by airlines is good example. Hence, we strongly caution against "effective competition" being viewed as necessarily involving all customers being charged the same low prices. It would be wrong to conclude from the presence of price discrimination that there is something automatically wrong with the functioning of the competitive process.

In energy, the CMA has concluded that price discrimination does genuinely reflect a lack of effective competition in part of the market. In the UK energy market, there are at least two fundamentally different groups of consumers: those who are engaged, and potentially willing to switch providers in any given period, and those who are disengaged (for a variety of reasons). The process of competition appears to be working effectively for engaged customers, who seek out the best Fixed-Term Tariff (FTT) deals. The process of competition is not delivering the desired outcomes for disengaged customers. That profit-maximising companies charge a substantially higher price to those consumers who do not switch is not surprising, but it does reflect the limitations of an effective competitive process to win these disengaged consumers, which results from their minimal sensitivity to competing offers.

Depending on precisely how the cap is designed and implemented, there is a significant risk that a cap will harm competition (see, in particular, our responses to Questions 2, 5 and 6 below). This may be why the objective is framed in terms of "the conditions for" effective competition having to be in place, rather than requiring *actual* effective competition to be in place. However, the cap may harm the regulator's ability to put in place measures that improve the "the conditions for" competition, or at least to test the effectiveness of such measures. In this case, there may be a contradiction within the Government's stated objective: the cap would protect certain customers, but it would simultaneously be hindering efforts to establish the conditions for effective competition in the market as a whole.

This contradiction becomes more serious in the wording of the Draft Bill's 'Review and termination' provisions (clauses 6-7): if the cap itself were a barrier to creating the conditions for effective competition, clause 7 dictates that it would still need to remain in place (until 31 December 2023), as the conditions for effective competition would not have been established. We discuss a way of overcoming this issue in our response to Question 4.

## 2. Does the text of the draft legislation enable this objective to be achieved?

Regarding the draft legislation's ability to meet its stated objective two central points can be made:

- (i) The protection offered by the cap is likely to be partial;
- (ii) It is far from clear that the conditions for effective competition will exist by the end of 2023.

### *(i) The protection offered by the cap is likely to be partial*

The impact of any cap will depend on its detailed design. However, as will be discussed further under Question 5, there is a real tension between protecting consumers and providing for effective competition. The more that consumers are protected by a price cap, the less incentive they have to engage with the market to gain the best deals. Even if there are still big gains to be made from switching, the cap may (falsely) reassure consumers so they stop shopping around and switching, reducing competitive pressure in the market. Moreover, the more that a cap reduces suppliers' rents from disengaged customers, the more they may be expected to adjust their pricing strategies, potentially increasing prices for engaged customers.<sup>1</sup>

This fundamental trade-off between the extent of consumer protection offered by a cap and the extent of its harmful effect on competition is well recognised. In designing its pre-payment meter (PPM) price cap the CMA addressed it by including 'head room'<sup>2</sup> to provide space for competition, i.e. the cap is set at a level somewhat above what is judged to be the efficient cost of supply. As a result, however, any protection will be partial. There will still be a gap between the cap for SVTs/default tariffs (from now on simply referred to as SVTs) and the competitive FTTs.

At the same time, the objective stated in Question 1 does not take explicit account of the heterogeneity of consumers.<sup>3</sup> If competition on FTTs is weakened by the cap, resulting in higher prices for engaged consumers, this would be the opposite of "protection" for such consumers.

The long term effect of a cap may also be hard to assess. While in the first year after the cap's introduction one would expect SVT prices charged by the former electricity incumbents and British Gas (the Big-6) to be below their level in the absence of a cap<sup>4</sup>, further into the future the true impact of the cap will be less clear, as it will become ever harder to discern what the

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<sup>1</sup> For example, while some consumers are consistently engaged or disengaged, there is also a spectrum of consumers who occasionally become engaged in the market - and may potentially switch at this point - but then become 'sticky' again. Suppliers may be expected to compete especially hard on FTTs to win engaged customers, if they expect a significant proportion of them to become sticky, given the potential to harvest rents from such customers later. This may lead suppliers to set even lower FTT prices than they would otherwise. A reduction in these later rents, due to a price cap, will reduce these competitive incentives of suppliers to offer lower FTT prices to win such customers, and thus FTT prices may be expected to rise.

<sup>2</sup> See paragraph 248, pg 59, Competition and Markets Authority (2016a), 'Energy market investigation: Summary of final report', available at: <https://assets.publishing.service.gov.uk/media/576c23e4ed915d622c000087/Energy-final-report-summary.pdf>.

<sup>3</sup> See Catherine Waddams Price and Minyan Zhu (2016), 'Empirical Evidence of Consumer Response in Regulated Markets', *Journal of Competition Law and Economics*, Vol 12 (1) pp 113-149; and Miguel Flores and Catherine Waddams Price (2013), 'Consumer behaviour in the British retail electricity market', Centre for Competition Policy Working Paper 13-10.

<sup>4</sup> It is important to emphasise the subtlety here: the cap should mean that SVT prices in year 1 are lower than they would have been in the absence of the cap, but this does not guarantee the energy bills of SVT consumers will be lower in the year following the cap's introduction as bills also depend on wholesale price movements, the costs of government policy and the quantity of energy a consumer uses.

‘counterfactual’ would have been. However, one can expect the cap to act as a ‘focal point’ so that firms with a large stock of unengaged consumers will price their SVT at or near the cap.<sup>5</sup>

***(ii) It is unclear that the conditions for effective competition will be in place by end-2023***

The CMA’s Energy Market Investigation concluded that the main issue leading to differential pricing between FTTs and SVTs was the unilateral market power which firms obtained through the weak customer response of around two-thirds of consumers<sup>6</sup>. It is not clear that this problem of consumer disengagement will be solved by the end of 2023. While we strongly support the principle of regularly reviewing the cap, as a means to limit any negative outcomes, one cannot say with certainty when, if ever, the issues identified by the CMA will be fully resolved.<sup>7</sup> Hence, as a matter of logic, imposing a time limit on the cap must introduce uncertainty as to whether consumers will be protected until the conditions for effective competition are achieved.

It is clear that the government and CMA *hope* that the roll-out of smart meters will play a central role in solving the issue of non-engagement<sup>8</sup>. However, questions surround the ability of smart meters to truly solve non-switching on a number of grounds, including:

1. The extent of the smart meter roll-out and the timeline for delivery remains uncertain: the government only promises that all households will be *offered* a smart meter by 2020<sup>9</sup>;
2. By definition, those consumers who opt-out of the smart meter roll-out will not receive any engagement enhancing benefits of smart meters;
3. There is limited evidence that smart meters, in and of themselves, increase the likelihood of switching<sup>10</sup>;
4. Until they are upgraded, the first generation of smart meters (SMETS1) may pose a disincentive to switch;
5. Significant uncertainty remains around how companies will use the data from smart meters and what smart meter tariffs they will offer.

Points 1. and 2. call into question whether the installed base of smart meters will be large enough to resolve the current lack of market engagement for many consumers. As a starting hypothesis, it seems likely that switchers, i.e. those on FTTs, will have a greater probability of taking the positive step to opt-in to having a smart meter than non-switchers, i.e. those on SVTs. While smart meters

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<sup>5</sup> Universities’ pricing decisions regarding their tuition fees are a classic example of this.

<sup>6</sup> See paragraph 154, pg 37, Competition and Markets Authority (2016a).

<sup>7</sup> Of course, non-switching is not automatically a problem, for example, if a consumer actively prefers their current supplier over rivals.

<sup>8</sup> See paragraphs 208-210, pg 49, Competition and Markets Authority (2016a). For the issue of price discrimination to end smart meters must not just increase general ‘engagement’ with energy consumption, they must specifically increase consumers’ willingness to switch suppliers and tariffs.

<sup>9</sup> The CMA’s report assumed: “The roll-out of smart meters to domestic customers is due to be substantially completed by the end of 2020”, paragraph 208, pg 49, Competition and Markets Authority (2016a).

<sup>10</sup> Regarding the wider term ‘engagement’ the CMA states: “There is limited evidence on the impact of smart meters on engagement in domestic retail energy markets – and our review of the international experience of smart meter roll-out....did not identify any studies that have specifically addressed this question”, paragraph 4.75, page 200, Competition and Markets Authority (2016b), ‘Energy market investigation - Provisional decision on remedies’, available at:

<https://assets.publishing.service.gov.uk/media/5706757340f0b6038800003b/Provisional-decision-on-remedies-EMI.pdf>.

may increase consumer engagement, the key issue is whether they do so at sufficient scale to resolve the current political controversies surrounding the energy market.

Smart meters are more likely to increase consumers' awareness of general energy consumption<sup>11</sup>. However, if consumer engagement in the market does not increase as a result, the unilateral market power of firms will remain and one would expect price discrimination to continue. Indeed, the fact that SMETS1 meters 'go dumb' after a change of supplier may be viewed as a disincentive to switch by households and so, everything else being equal, reduce the likelihood that a household with a SMETS1 meter will switch supplier.

Point 5. highlights that until there is a sizeable installed base of smart meters there is uncertainty as to how firms will use the meters' capabilities and the data they generate. The continuous measurement of consumption could enable tariffs allowing a specified level of consumption for a fixed price, as in telecoms, thereby simplifying the comparison of offers and increasing switching. However, time of use tariffs have the clear potential to increase consumer confusion, while the data generated by smart meters may enable firms to segment energy consumers ever more finely leading to greater price discrimination.

The CMA viewed its remedies for consumer disengagement as a 'package' that did not rest entirely on the smart meter roll out. For example, the CMA also proposed that a Disengaged Consumer Database<sup>12</sup> be established which would make it easier for rival suppliers to send marketing communications to consumers who had not switched for more than 3 years. Deller et al (2017a)<sup>13</sup> review alternative options for such a database highlighting that if consumers have to opt-in to the database there will be far lower participation than if consumers have to opt-out from the database. However, the ability to use opt-outs to gain consent for participation faces considerable legal uncertainty<sup>14</sup>. We note that a trial of a process similar to the CMA's disengaged consumer database remedy by Ofgem has shown some encouraging results<sup>15</sup>, although questions remain about whether the trial results generalise to the broader base of SVT consumers, some of whom are likely have a lower propensity to switch than those taking part in the trial.

Overall, our assessment is that CMA package of measures will increase consumer engagement (including switching), but the improvement is likely to be insufficient to address the political

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<sup>11</sup> For robust evidence on smart meters' impacts randomised control trials are required where houses who have smart meters installed are randomly selected and compared to a control group of households without smart meters. Simply asking smart meter users for their views/satisfaction of smart meters is likely to lead to biased results, as the households, especially early adopters, who choose to have a smart meter installed are likely to be relatively engaged/have a relatively positive view of smart meters' benefits.

<sup>12</sup> See paragraphs 232-235, pg 55 of Competition and Markets Authority (2016a).

<sup>13</sup> See Section 4, pg 25-30, Deller, D., Bernal P., Hviid M. and Waddams Price C. (2017a), 'Collective Switching and Possible Uses of a Disengaged Consumer Database', Centre for Competition Policy report commissioned by Ofgem, available at:

<http://competitionpolicy.ac.uk/documents/8158338/19064125/Collective+Switching+Report+-+August+2017.pdf/127c78b6-faad-4496-b198-f56862230896>.

<sup>14</sup> See Appendix B, pg 73-79, Deller et al (2017a).

<sup>15</sup> Ofgem (2017) reports the process in its trial led to a 5-8 percentage point increase in the 3-month switching rate compared to a control group. However, the report notes the trial occurred during the winter, involved customers from only two suppliers, and the suppliers reported price increases during the trial period. More significantly, particularly sticky customers were excluded from the trial including: those only consuming a single fuel, those receiving the warm home discount, those on the priority services register and those who had opted out of receiving marketing. In other words, it is not automatic that the trial results apply to these groups. See Ofgem (2017), 'Small Scale Database trial – Research Results', available at: [https://www.ofgem.gov.uk/system/files/docs/2017/11/small\\_scale\\_database\\_trial\\_paper\\_pdf.pdf](https://www.ofgem.gov.uk/system/files/docs/2017/11/small_scale_database_trial_paper_pdf.pdf)

pressures surrounding this market. CCP research on the effectiveness of demand-side remedies, across a range of sectors, finds that such remedies can be valuable for enhancing consumer engagement, facilitating switching, and driving more effective competition, but that they are unlikely to resolve all competition concerns in markets where firms are able to discriminate between engaged and unengaged customers.<sup>16</sup> In the case of energy, even after the CMA's remedies have had time to work, it is likely that a block of non-switchers will remain and profit-maximising firms will retain an incentive to charge these disengaged consumers higher prices.

### **3. Could it be better achieved by other legislative or non-legislative means?**

Following its lengthy and detailed Energy Market Investigation, the CMA determined that the most proportionate way of addressing the concerns that it had identified was through a remedy package designed to enhance consumers' engagement and thereby drive more effective competition. It specifically considered the option of wider price regulation (beyond the transitional cap for PPM customers) and the majority rejected this remedy.

Given this background, if Parliament takes the view that the current price differential between FTTs and SVTs is unacceptable, we see little ability for non-legislative means to resolve the issue. As noted above, firms are responding to strong market incentives when setting their prices and we believe the CMA's remedies will not fully address the issue of non-switching. Firms may not bow to public/political pressure, and the results may damage the market process and be difficult to monitor. Also, as Dermot Nolan has noted, an Ofgem imposed tariff cap lacking legislative backing would be open to judicial review, especially if its reach were to extend beyond vulnerable consumers.

Furthermore, a decision to intervene to reduce the price differential is an explicit distributional judgement: consumers on SVTs are the intended beneficiaries, but the intervention exposes engaged FTT customers to the *risk* of price rises. Given that the decision involves such an explicit distributional judgement, it is appropriate for elected representatives in Parliament, rather than an unelected regulator, to take the final decision.

We briefly discuss two legislative alternatives to a tariff cap: (a) opt-out collective switches, and (b) nationalisation. While opt-out collective switches potentially offer a robust long-term solution to non-switching, nationalisation simply alters the nature of the information problem facing policymakers.

#### ***(a) Opt-out collective switches***

Once the decision to intervene has been taken, the cost of supplying SVT customers in the absence of market power needs to be determined. This is the central challenge when determining any tariff cap. An approach, discussed in detail by Deller et al (2017a), which still utilises competition to determine the cost of supply, is an opt-out collective switch.

As the CMA notes, the ability for firms to charge a higher price for SVT customers is the result of unilateral market power, and a collective switch tackles this market power directly. The non-switching by consumers means there is a lack of competitive pressure on the prices they face and the collective switch process is explicitly designed to create such competitive pressure. The

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<sup>16</sup> See Fletcher, A. (2016) 'The Role of Demand-Side Remedies in Driving Effective Competition: A Review for Which?', available at: <https://www.staticwhich.co.uk/documents/pdf/the-role-of-demand-side-remedies-in-driving-effective-competition-456067.pdf>.

collective switch would be open to all consumers who had been on an SVT for a given number of years and all eligible consumers would be enrolled in the collective switch unless they took a positive step to opt-out.<sup>17</sup> As explained by Deller et al (2017a), requiring households to opt-in is not robust to non-engagement: those who do not switch supplier are also unlikely to take the positive step of opting-in to a collective switch. It is the opt-out that makes the proposal different to existing collective switches in the UK, such as Which?'s 'The Big Switch'.<sup>18</sup>

The collective switch would take the form of a reverse (falling price) auction, where firms would compete to offer the lowest cost of supply, subject to minimum quality requirements<sup>19</sup>. All firms would be allowed to enter the auction and consumers would be split into tranches, of perhaps 10,000 consumers, that would be small enough for new entrants to bid for. The auction process would begin at a price that was high and would then fall, with high-cost firms initially reducing the number of tranches they would supply until eventually they would withdraw from the auction altogether. The auction would stop when the number of tranches which firms were willing to supply in aggregate equalled the number of tranches on offer.<sup>20</sup> Competition *for* the market rather than *in* the market should lead to the resulting prices being closer to the competitive level for FTTs. Since an opt-out collective switch replaces consumer engagement rather than encouraging consumers to become more engaged, it would not address consumer engagement directly, and would need to be repeated at regular intervals unless other measures had been successful.

While an opt-out collective switch has attractive properties from a competition perspective, Deller et al (2017a) note the scale of the change involved presents challenges. In particular, there would be the operational challenge of switching millions of consumers' retail supply contracts in a short space of time and the legality of obtaining consent via an opt-out faces some uncertainties.<sup>21</sup> These implementation issues mean opt-out collective switches may be better suited to providing a competitive default tariff in a radically changed energy future<sup>22</sup>, than as a near term fix. Also, some consumers may dislike being involuntarily switched, even if they have the potential to opt out. Moreover, just as for a price cap, a collective switch may have distributional implications; any reduction in the price paid by non-engaged customers may be detrimental for engaged customers on FTTs.

As Deller et al (2017a) highlight, the opt-out collective switches (termed 'municipal aggregation') that have been applied in the US have received local democratic approval beforehand.<sup>23</sup> Here too,

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<sup>17</sup> Allowing an opt-out is important as some consumers positively value their current supplier over certain rivals on specific dimensions and so may be actively choosing to remain with a supplier which does not offer the lowest price. See Deller, D., Giulietti M., Loomes G., Waddams Price C., Moniche Bermejo A. and Jeon J.Y. (2017b), 'Switching Energy Suppliers: It's Not All About the Money', CCP Working Paper 17-5, available at: <http://competitionpolicy.ac.uk/documents/8158338/17199160/CCP+WP+17-5+complete.pdf/fdaaed88-56e5-44f9-98db-6cf161bfb0d4>

<sup>18</sup> Evidence on the performance of opt-in collective schemes is provided on pg 7-17, Deller et al (2017a).

<sup>19</sup> These quality requirements would relate primarily to billing, customer services and any government initiatives.

<sup>20</sup> This auction mechanism has been used for a number of years in New Jersey to determine the wholesale component of consumers' energy bills and is discussed in detail by Loxley, C. and Salant, D. (2004), 'Default Service Auctions', *Journal of Regulatory Economics*, 26(2), pg 201-229.

<sup>21</sup> The operational challenges are discussed on pg 38-42 of Deller et al (2017a), while the legal uncertainties are discussed in Appendix B, pg 73-79.

<sup>22</sup> Dermot Nolan floated this idea in a speech to the 2017 Energy UK conference, see: Dermot Nolan, 'Ofgem's vision for the retail energy market' (Energy UK Annual Conference, London, 19 October 2017), available at [https://www.ofgem.gov.uk/system/files/docs/2017/10/euk\\_final\\_19.10\\_v2.pdf](https://www.ofgem.gov.uk/system/files/docs/2017/10/euk_final_19.10_v2.pdf).

<sup>23</sup> See pg 17-23, Deller et al (2017a).



for the reasons above, we argue that a roll-out of opt-out collective switching should have legislative backing.

### **(b) Nationalisation**

For completeness, we briefly mention nationalisation as an alternative mechanism to end price discrimination, and conclude that it is not a panacea. Full nationalisation could allow the government to determine pricing in the energy market, directly end price discrimination and set breaking even rather than maximising profits as the industry's objective. However, nationalisation does not remove the fundamental problem of identifying the minimum cost of supply. Private profit-maximising firms have strong incentives to minimise costs (this is perceived as a key benefit of privatisation), but where possible will charge a price above cost to maximise profits. In contrast, a state-owned firm with a break-even objective will set price broadly equal to the cost of supply, but in the absence of competition will have weakened incentives to drive the cost of supply down to the *efficient* cost of supply. Nationalisation offers a direct mechanism to end price discrimination, but does not guarantee that consumers will experience lower prices over the long-term.

Another possible approach would be for government to set up one or more public sector energy firms, to compete against existing suppliers. However, this seems unlikely to solve the issue of high prices being charged to disengaged consumers, since the public sector supplier will presumably struggle to win many as customers (absent any forced customer transfer).<sup>24</sup>

## **Provisions of legislation**

### **4. Are the draft legislation's provisions necessary, workable, and clear? If not, what changes need to be made?**

Overall the draft legislation's provisions appear necessary and reasonably clear. However, regards to whether the provisions are workable, we point the reader to our Question 5 response. It is clear that matters (a) to (e) in clause 1(6) cannot all be satisfied to their full extent simultaneously: there are inevitable trade-offs between them. We also note that while clause 1(4)(a) and (b) are sensibly broad, there is the potential for the market to evolve in a way that reduces the relevance of these particular provisions (see response to Question 7) thereby reducing the power of the legislation. In particular, we note there is no guarantee the market will evolve in ways that help to meet Parliament's objectives.

If a tariff cap is to be imposed, we welcome it being implemented through legislation, on the basis that it is left to Ofgem, and specifically its decision-making arm the Gas and Electricity Markets Authority (GEMA), to determine the precise design of the cap. Designing the cap will be an in-depth technical exercise and Ofgem is in a reasonable position to assess the issues in a balanced fashion. However, the effect of the cap will depend almost completely on its detailed design, so by delegating responsibility for its design Parliament is unable to be sure what effects (both intended and unintended) the cap will have. In particular, the legislation appears to make no provision for how Ofgem is to balance the competing pressures detailed in clause 1(6) (a) to (e).

Given that there is a real risk the cap will actually harm competition (see, in particular, our responses to Questions 2, 5 and 6), we strongly recommend that changes are made to the 'Review

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<sup>24</sup> We note an unknown proportion of disengaged consumers may respond positively to the public sector/not-for-profit/local branding of these entities and may switch to them as a result.

*and termination*' provisions under clauses 6-7 so as to allow the cap to be removed if the harm is substantial. The discussion below summarises our thoughts on three issues at play within these provisions: (i) the factors Ofgem may consider under its clause 6 review, (ii) the grounds on which the Secretary of State (SoS) may extend or terminate the cap, and (iii) the consideration the SoS affords to Ofgem's clause 6(4) report. We make recommendations where appropriate.

#### ***(i) The factors Ofgem may consider under its clause 6 review***

We predominantly support the institutional arrangement in clauses 6(1)-(5) which requires Ofgem to review whether the conditions are in place for effective competition; like designing the tariff cap, Ofgem has the skills and knowledge to perform this review. However, we are concerned there may be tension in having Ofgem both design the cap *and* perform a review of the market after introduction of the cap. We believe the post-cap review should include an assessment of whether the cap itself is having a substantial negative effect on competition and particular consumer groups. However, this raises a question as to whether Ofgem can produce a review of an instrument that it has itself designed which is, and is perceived to be, impartial. We suggest the review process needs to demonstrate independence from those who have designed the intervention.

The wording of clause 6(4)(a) provides that, after conducting its review into whether the conditions are in place for effective competition, Ofgem must '*produce a report on the outcome [of the review], which must include a recommendation as to whether or not the Authority considers that the tariff cap conditions should be extended to have effect for the following year*'. We note that there is ambiguity in the wording of this clause, since the clause could be read as implying that Ofgem's recommendation can be based on factors other than 'the conditions for effective competition', i.e. it does not explicitly acknowledge the criterion on which the SoS will base his/her decision on whether to extend the tariff cap conditions. However, as we outline in (ii) below, we believe both the Ofgem review and the SoS decision should be based on more than merely the 'conditions for effective competition' criterion in order to allow for the cap to be removed if it has substantial negative impacts.<sup>25</sup> We also wonder whether the Ofgem review should explicitly include provision to assess whether the cap is being circumvented by companies or if it has lost its relevance.<sup>26</sup> For these reasons, we recommend preserving the wording of clause 6(4)(a) in its current (broad) form, but to amend clauses 6(1) and (2) so that they explicitly require Ofgem to evaluate: (a) the impact the cap has had on competition, and (b) whether the cap is being circumvented by companies.

#### ***(ii) The grounds on which the Secretary of State may extend or terminate the cap***

As clauses 7(1)-(3) have the effect of giving the SoS the final say on whether to end/extend the cap (by means of the statement that (s)he makes under clause 6(6)), we note the potential for the decision to contain a significant political element, albeit one that is currently constrained by a single criterion, whether the 'conditions are in place for effective competition for domestic supply contracts'. It is important to consider whether this invites the potential for distributional judgements to influence whether the cap is extended. While the consideration of distributional issues is not necessarily inappropriate, we believe this would significantly increase the likelihood

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<sup>25</sup> On the prospects of the cap having excessive detrimental impacts, see our responses to Questions 9 and 12.

<sup>26</sup> On the prospects of the cap being circumvented by companies, see our response to Question 7.

the cap will remain in place until the end of 2023. Introducing protections is generally easier politically than removing them.

We believe there exists a significant weakness in the wording of clauses 7(1)-(3) which only allows the SoS to terminate the cap once the conditions are in place for effective competition. Under a literal interpretation of these clauses, the use of the single 'conditions for effective competition' criterion has the effect of tying the hands of the SoS when, in the event of the cap itself having a substantial negative impact on competition, (s)he is compelled to keep the cap in place because the conditions for effective competition would not yet have been established.

To prevent this problematic scenario occurring in practice, we recommend amending the wording of clauses 6(6) and 7(1)-(3) to insert an additional criterion enabling the SoS to terminate the cap where (s)he considers the cap to be having a substantial negative impact on competition. We anticipate that this would read similar to the following:

*Review and termination*

**6 Review of competition for supply contracts**  
[...]  
(6) After considering the report the Secretary of State must publish a statement setting out whether the Secretary of State considers –  
**(a) that conditions are in place for effective competition for domestic supply contracts, and**  
**(b) that the tariff cap conditions are having a substantial negative impact on competition for domestic supply contracts..**  
[...]

**7 Extension and termination of tariff cap conditions**  
(1) The tariff cap conditions ~~cease~~ **continue** to have effect at the end of year 2020 unless the statement published by the Secretary of State in that year under section 6 is to the effect that –  
**(a) the conditions are ~~not yet~~ in place for effective competition for domestic supply contracts, or**  
**(b) the tariff cap conditions are having a substantial negative impact on competition for domestic supply contracts,**  
in which case the conditions **cease to** have effect for the year 2021.  
[...]

***(iii) The consideration that the Secretary of State affords to Ofgem's clause 6(4) report***

If the government chooses to retain the current single-criterion wording in clauses 7(1)-(3), a potential issue exists in relation to the weight that the SoS should afford to Ofgem's clause 6(4) report on the outcome of its review into the conditions for effective competition. If Ofgem's report concludes the conditions *are* in place for effective competition so that Ofgem recommends terminating the tariff cap,<sup>27</sup> there could be circumstances where the SoS chooses to deviate from this recommendation and renews the cap. If the Bill required the SoS to consider both competition and, for example, distributional criteria as part of his/her decision, deviations between Ofgem's report and the SoS's statement would be foreseeable. However, given the Draft Bill requires the

<sup>27</sup> Consistent with Ofgem's duty under clause 6(4)(a).

decision to be dictated by ‘conditions for effective competition’ alone – an assessment that Ofgem is better-placed to undertake than the SoS in terms of expertise, resources and having conducted its clause 6(1) review – we would anticipate that the SoS will follow Ofgem’s recommendation in the vast majority of cases.

Nevertheless, with the Draft Bill establishing the potential for the SoS to deviate, it is important that due consideration is paid to Ofgem’s report before a decision is made on whether to extend the cap. Short of reassigning the SoS’s quasi-judicial decision-making role to Ofgem in order to achieve this (which we do not advocate),<sup>28</sup> there is a strong argument for incorporating safeguards into the Draft Bill that would ensure the SoS affords due consideration to Ofgem’s clause 6(4) report. This could be facilitated by requiring the SoS to either accept the advice that Ofgem provides in its report *or* to otherwise explain why (s)he has rejected that advice (a recommendation that has previously been submitted by the Leveson Inquiry<sup>29</sup> and the Lords Communications Committee<sup>30</sup> in the context of media mergers and market reviews). We agree with Leveson’s conclusion that requiring explanation would ensure both higher standards of decision-making and also provide the transparency needed to facilitate effective conditions for judicial review and appeal.<sup>31</sup> This would require a tightening-up of the wording of clause 6(6) to make it clear that, in the event of a deviation from Ofgem’s recommendation, the SoS’s statement must include an explanation of the reasoning behind it.

#### **5. Are the five matters listed in clause 1(6)(a) to (e) compatible? What priority should each one have?**

It is clear that the five matters listed in clause 1(6)(a) to (e) are *not* fully compatible, as there are obvious trade-offs between the extent of protection in 1(6)(a) and the extent to which 1(6)(c) to (e) can be met. Given the risks of a poorly designed tariff cap, we do feel it is important that Ofgem considers 1(6)(b) to (e) in the design of the tariff cap, but Parliament needs to be realistic that not all matters in 1(6)(a) to (e) can be met simultaneously and fully. Also, we note that the phrase “must have regard to” in clause 1(6) gives Ofgem significant discretion in how it balances these competing matters, consistent with its approach to its wider statutory duties.

Our response to Question 2 highlights a fundamental trade-off between the level of protection offered to consumers, clause 1(6)(a), and the extent to which market competition is facilitated, clause 1(6)(c). The imposition of a cap as an intervention that overrides the existing market process, is a substitute rather than a complement for effective competition around SVTs. The tighter (lower) the cap, the less freedom there is for firms to set prices and the greater the potential for unintended consequences. Clause 1(6) might usefully therefore emphasise the importance of ensuring that the cap is set at a level that does not unduly damage the competition that already exists for FTTs. In our view, this will be key to the cap’s overall success. It is also consistent with the approach taken by the CMA to the PPM cap, which is designed to incorporate ‘head room’, i.e. it is

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<sup>28</sup> We acknowledge the BEIS Secretary’s recent comments to the BEIS Committee, in which he indicates that the purpose of the Draft Bill is to ensure Ofgem goes further in exercising its powers; Business, Energy and Industrial Strategy Committee, *Energy price cap inquiry: Oral evidence* (HC 470, 2017-18), [Q145](#). In light of this, it would therefore seem odd for Ofgem to have the final say on whether or not the cap should be extended.

<sup>29</sup> Lord Leveson, *The Leveson Inquiry: An Inquiry into the Culture, Practices and Ethics of the Press* (Independent report, 2012), vol.3, Part I, Ch 9, [para 6.11](#).

<sup>30</sup> House of Lords Communications Committee, [Media plurality](#) (HL 2013–14, 120–I), para 219.

<sup>31</sup> Leveson (2012), vol.3, Part I, Ch 9, para 6.12.

set somewhat above their estimates of the efficient cost of supply. By definition, including head room in the cap reduces the achievement of protection (clause 1(6)(a)).

Our response to Question 13 highlights a range of evidence produced by CCP<sup>32</sup> showing that monetary savings is the most consistent predictor of switching in the energy market. Currently, the largest savings result from the price difference between SVTs and FTTs, hence, imposing a cap to limit this price differential must reduce the level of switching (all else being equal) and so there is an inherent trade-off between 1(6)(a) and 1(6)(d). In particular, a cap is likely to reduce the rate of switching by SVT customers. Having said this, switching and the switching rate are only 'intermediate objectives' rather than being of per se value. Market engagement can be valuable even if it does not result in a switch, since it enhances firms' incentives to offer a good deal; while a switch is only beneficial if the consumer gains, i.e. they receive a lower price or a better quality of service etc.<sup>33</sup> The final objectives, which we suggest should be the focus of the Select Committee, are lower prices and better customer service.

Lastly, we note that there may be some tension between 1(6)(a) and 1(6)(e). The nature of economic regulation is that a regulator has less information about firms' cost of supply than firms themselves, and firms have an incentive to report costs in a way that results in lighter regulation. This means there is always some uncertainty about where the efficient cost of supply lies and the tighter a cap is set, the greater the risk that it is set too low; including 'head room' in the cap's design increases the safety margin around 1(6)(e). However, since the CMA found that some of the price differential between FTTs and SVTs was due to inefficiency, the cap needs to reflect potential efficiency savings which are difficult for the regulator to estimate (see Question 12).

## **6. Should the cap be an absolute cap? If not, what kind of cap should be set and why?**

The main debate is whether the cap should be 'absolute' or 'relative' in nature. Below we outline how the distinction between the two is blurred because a well-designed cap will probably only set a maximum SVT price, but the calculation of this maximum price may be linked to a 'benchmark' incorporating the other prices charged in the market. In other words, even if the cap is expressed in absolute terms, its calculation may be relative.

Referencing other tariffs potentially provides information relevant to the cap designer's core task: establishing the efficient cost of supply in the absence of market power. We are clear that a basic 'relative' cap, i.e. a simple limit on the difference in price between a supplier's own FTT and SVT

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<sup>32</sup> See for example, David Deller, Monica Giuliatti, Graham Loomes, Catherine Waddams Price, Ana Moniche Bermejo and Joo Young Jeon (2017b), 'Switching Energy Suppliers: It's Not All About the Money', CCP Working Paper 17-5; Catherine Waddams Price and Minyan Zhu (2016a), 'Empirical Evidence of Consumer Response in Regulated Markets', Journal of Competition Law and Economics, 12(1), pp. 113-149; Miguel Flores, M. and Waddams Price, C. (2013), 'Consumer Behaviour in the British Retail Electricity Market', CCP Working Paper 13-10.

<sup>33</sup> While the benefit of switching to consumers is not automatic, certain parties who may provide evidence to the Select Committee, especially Third Party Intermediaries (including Price Comparison Websites), have business models where their profits are maximised when switching is maximised. The ambiguous meaning of the switching rate is discussed on pg11-12 of Deller, D., Errington E., Hviid M. and Waddams C. (2016), Centre for Competition Policy consultation response to the House of Lords Select Committee on Economic Policy's inquiry into 'The Economics of UK Energy Policy', available at: <http://competitionpolicy.ac.uk/documents/8158338/11690925/8+CCP+Response+to+House+of+Lords+Economics+of+Energy+Inquiry+-+September+2016.pdf/9c2d64eb-81b8-4937-9514-b102e940e089>

offerings, is potentially detrimental, but suggest further detailed work is required to establish the best mechanism for setting the cap.

### *Reasons for rejecting a basic relative cap*

Our reasons for rejecting a basic relative cap are threefold. As compared with an absolute price cap:

- (i) It may have a limited impact on the SVT prices of the Big-6;
- (ii) It poses a greater risk of distorting competition in the FTT market; and
- (iii) The choice of what price differential to allow is essentially arbitrary.

We want to make clear that the notion that a basic relative cap represents “less intervention” is false; the extent of intervention should be based on the impact of the intervention rather than the number of pages of text required to explain the intervention.

Regarding (i), different firms have different proportions of their consumers on FTTs and SVTs. The Big-6, being the former incumbents, have a much greater proportion of their customers on SVTs, which are the more profitable product. To protect their profits, and knowing that their SVT customers are unlikely to switch, the Big-6 are likely to comply with a basic relative cap by increasing their FTT prices by significantly more than they reduce their SVT prices. While increasing their FTT prices means they will lose some of these customers, the profits lost through this would be lower than from an equivalent reduction in SVT prices. In practice, the impact on the SVT prices of the Big-6 may be limited.

That all the Big-6 suppliers have a clear mechanical incentive to raise their FTT prices, possibly by significant amounts, means there is a risk that a formal relative cap will prove detrimental to competition in the FTT market. Firstly, any FTT customers who are with the Big-6 are likely to face noticeable price increases, i.e. harm, unless they switch to a non-Big-6 provider. Second, regarding (ii), that all the Big-6 simultaneously have an incentive to raise their FTT prices will tend to lead to less pricing pressure in the FTT market and this reduction in pricing pressure may have the indirect effect of encouraging smaller suppliers to raise their FTT prices and rival Big-6 firms to raise their prices even further. Moreover, the more engaged consumers that the Big-6 lose to their smaller rivals, the greater their incentives under a basic relative cap to raise SVTs higher still and simply harvest the rents from non-switchers.

There is past evidence of large firms retreating to their stock of sticky customers, with a consequential detrimental effect on competition, from the UK experience of regional non-discrimination clauses (see response to Question 14). However we recognise that there is an important difference in market structure between that experience and today: there are now more than 40 suppliers other than the Big-6. This may be expected to mitigate the harm to FTT competition from a relative cap to some extent. The pricing incentives of these smaller suppliers will be less directly affected by a relative cap since (a) they have a greater proportion of FTT customers to SVT customers and (b) most of their customers will have switched at least once<sup>34</sup> so they have a stock of customers who are more price sensitive. As such, the direct incentive for these non-Big-6 firms to raise their FTT prices will be relatively small, and their large number means that even after Big-6 FTT prices rise, significant pricing pressure is likely to remain from other small

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<sup>34</sup> By definition, households who had a supply contract prior to liberalisation must have switched away from an incumbent to be with one of the new entrants.

suppliers. One would thus expect the detrimental impact on FTT competition of a relative cap to be smaller than in the case of the regional non-discrimination clauses.<sup>35</sup>

Regarding (iii), we believe there is no economic logic that can be used to determine what is a 'reasonable' price differential apart from that produced by the market process. Any set price differential would be a value judgement and/or entirely political decision. Other caps enable the application of alternative established, regulatory methodologies to estimate the efficient cost of supply.

### *Alternative approaches to the cap*

We now briefly described three alternative approaches to the cap that blur the line between absolute and relative caps. A crucial element in all of these cap designs is that the cap cannot be manipulated by the firm subject to the cap. We do not recommend a particular mechanism, but offer these examples as ideas for further investigation.

The first approach would be to follow the design of the CMA's PPM cap. Data from the CMA's Energy Market Investigation relating to smaller suppliers and their FTTs would be used to form a 'historical' estimate of the efficient cost of supply, after adjusting for certain differences between the smaller and larger suppliers. This historical estimate would be updated with movements in underlying cost indices, such as wholesale costs.<sup>36</sup> The CMA has argued that using historical data and exogenous cost indices means the resulting PPM tariff cap is non-manipulable. One risk with this approach is that cost indices do not accurately reflect all the cost changes experienced by firms, and this risk is likely to increase the longer the cap remains in place.

Second, the SVT cap could be set with reference to the FTT prices charged by all other firms in the market. In other words, the SVT cap for firm A would be set with reference to the average<sup>37</sup> FTT price after excluding firm A's FTT price from the average, while the SVT cap for firm B would be set with reference to the average FTT price after excluding firm B's FTT price etc.<sup>38</sup> This process would mean that every firm charging an SVT would have a slightly different tariff cap. The exclusion of a firm's own FTT price from calculating its SVT cap is critical to ensuring the cap cannot be manipulated by the firm's own actions. More importantly for the functioning of FTT competition, this way of calculating the average FTT price ensures all firms retain an incentive to undercut the other firms' FTT prices. If the average included a firm's own FTT price, sophisticated firms would anticipate that all firms would have an incentive to raise their FTT price and so the cap could encourage co-ordinated price rises.

The third suggestion for a benchmark would be to reference the prices charged by energy suppliers owned by local authorities, such as Robin Hood Energy. Assuming that these suppliers are run efficiently on a not-for-profit basis (this would need checking), they could provide a non-manipulable cost of supply estimate with which to reference the SVT cap for profit-making suppliers. To be a valid benchmark it would be necessary to ensure the not-for-profit firms forming the reference price were not loss making, otherwise the benchmark would be set too low. Indeed, there is a wider point that (as with any benchmark) thought would need to be given to whether to

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<sup>35</sup> This statement is reliant on a reasonable number of independent suppliers remaining in the market. We emphasise independent, since if smaller suppliers operate using white-labelling or have other links to larger suppliers they may be more akin to alternative brands rather than truly independent firms.

<sup>36</sup> See paragraph 246, pg58, Competition and Markets Authority (2016a).

<sup>37</sup> Probably a weighted average of some kind.

<sup>38</sup> We thank Kai-Uwe Kühn, Centre for Competition Policy and Department of Economics, University of East Anglia for pointing out the attractive properties of this benchmark.

apply adjustments to reflect differences between small suppliers' FTT costs and larger firms' SVT costs including: policy costs<sup>39</sup>, different types of customer base<sup>40</sup> and hedging strategies<sup>41</sup>. Not accounting for these differences may have unintended consequences which could be problematic.

In all three of these cases, we have discussed how to set an appropriate 'benchmark', but would recommend that 'headroom' is also included, to limit any undue harm to existing FTT competition. We note, however, that the extent to which SVT prices can be constrained without increasing FTT prices depends on the extent to which relatively high SVT prices result in abnormal profits/excess inefficiency. The CMA concluded that there were in fact significant abnormal profits/excess inefficiency. An alternative argument, put forward by Stephen Littlechild<sup>42</sup>, is that the Big-6 are not making abnormal profits, nor are they inefficient, but that the higher SVT prices are required to cover fixed costs. If Littlechild's argument were correct, any cap that limited SVT prices would lead mechanically to higher Big-6 FTT prices (and/or the Big-6 exiting the market over the long run).

## **7. Should the cap be only on Standard Variable Tariffs and default tariffs?**

When deciding what the cap should be applied to, it is important to realise that the real cause of SVT consumers being charged higher prices is their decision not to switch tariff/supplier. Firms already know who their inactive consumers are and it is likely that they will continue to use this information after a cap is introduced to price discriminate between consumers. At the moment a particular type of tariff, SVT, corresponds closely with non-switchers. We welcome the phrasing of the legislation to cover all default tariffs to prevent circumvention of the legislation by relabelling SVTs.

However, we have some concern about the proposed definition within the draft legislation of 'default rate' as the rate applying if a consumer 'fails to choose an alternative rate'. This could potentially lead suppliers to encourage to consumers to switch to a rate above the cap with just enough consent to make this count as a choice and therefore not a 'default rate'. It may be valuable therefore to incorporate a concept of 'active consent' within this definition (i.e 'fails to actively consent to an alternative rate').

Even with this wording change, a firm could still potentially offer a tariff above the cap if a consumer actively chose to be on the tariff. Once the cap is imposed, it would seem unlikely that a firm could get many (any rational) consumers to switch to such a tariff without using misleading/confusing advertising, since it would require a consumer to actively consent to an avoidable price increase. Moreover, it is possible that the cap will function like a Recommended Retail Price (RRP), so that setting a price above the cap, even where the cap does not strictly apply, will harm a company's reputation and so they will avoid this practice.

Nevertheless, the extent to which reputational concerns are a binding constraint on the Big-6 incumbents is unclear given the history of unfavourable coverage in this sector. It might be possible

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<sup>39</sup> Only suppliers with more than 250,000 consumers are required to meet Energy Company Obligations (ECO).

<sup>40</sup> For example, if former incumbents had a larger stock of customers with bad debt this could increase their costs relative to other firms

<sup>41</sup> Hedging is a form of insurance for wholesale energy costs which in theory enables a more stable retail price to be offered, but like all insurance comes at a price. A common accusation from larger suppliers is that new entrants do not engage in hedging.

<sup>42</sup> See second paragraph, second column, pg 10 of Littlechild, S. (2017), 'Competition and Price Control in the UK Energy Market', Network, Issue 63 June 2017, available at: <https://www.accc.gov.au/system/files/network%20june%202017%20%28D2017-00045379%29.pdf>



to increase the RRP effect of a cap by requiring firms to notify a consumer whenever a tariff<sup>43</sup> is expected to deliver a bill above that implied by the cap, including a statement of how much worse-off the consumer is by having a tariff not covered by the cap. Alternatively, the risk that the cap can be circumvented in ways that are not currently anticipated suggests that it would be sensible to specify that the Ofgem review process includes looking at whether the cap is being circumvented/has lost relevance.

#### **8. Should the cap be intended to have the same impact on all suppliers?**

The cap should be designed to address the perceived problems in the energy market and follow the points laid out in the rest of this document. The design of the cap should be 'neutral' in the sense that it is not deliberately designed to punish or reward particular types of firms. However the nature of the 'problem' of non-switchers is unevenly distributed across firms; non-switchers remain disproportionately with the Big-6, so a cap will have a particularly large impact on them and, if effective, would be expected to reduce their profitability, all else being equal. The crucial point is that the cap should be set according to a consumer's or a tariff's characteristics, rather than a firm's characteristics, so that a high-priced SVT from a small entrant would be equally affected as a similar tariff set by the Big-6.

#### **9. Should the cap be temporary? If so, for how long should it apply?**

As noted in our response to Question 1, there is no guarantee that the issue of non-switching will be resolved by the end of 2023. Equally, a cap designed today could become irrelevant, or worse, create new problems prior to 2023. Therefore we fully support a meaningful annual review of competition in the domestic energy market as laid out in clauses 6(1) to (5). Indeed, as discussed in our response to Question 4, we would suggest this review process is strengthened to make explicit Ofgem's ability to recommend the cap be removed if it is found to have substantial negative impacts and, moreover, that the SoS is afforded the power to terminate the cap on these grounds. From a perspective of pure logic, setting an arbitrary end date for the legislation does not seem sensible, although, we note that from a practical perspective it may force a detailed and valuable revisiting of the tariff cap issue in 2023.

#### **10. How will the roll out of smart meters affect policy on the tariff cap?**

As noted in our response to Question 2, it is questionable whether the impact of smart meters will be sufficient in the short-term to resolve the issue of non-switchers. In and of itself the type of meter that a household uses should not affect their eligibility to be covered by a cap. However, smart meters do raise two issues:

- (i) Whether the 'opt in' to receive a smart meter counts as engagement; and
- (ii) How the tariff cap is calculated for non-standard tariffs.

Regarding (i), smart meter installation currently requires consumers to take a positive decision, and some might argue that this indicates activity/engagement such that these consumers should not receive protection from the cap. Ultimately, who is targeted for protection is a decision for Parliament; however, we would suggest that, until evidence is presented to the contrary, the ability of smart meters to increase switching is not proven, so those who have smart meters may remain disengaged from the switching market. If a smart meter meant a consumer was no longer subject

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<sup>43</sup> There would be an exemption from this notification process for PPM tariffs and tariffs with environmental claims.

to the cap, there would be a clear incentive for suppliers to encourage households to have smart meters fitted. While this may be beneficial to advancing the smart meter roll-out, it would reduce the proportion of households to which the cap would offer some protection.

Regarding (ii), in the current world where most tariffs involve a standing charge and a unit rate, it is relatively straightforward to calculate how a cap would apply. However, if smart meters lead to a proliferation of tariff designs beyond the standing charge/unit rate model, the cap designer will need to establish how the cap should function in each case. In particular, it is not entirely clear how a cap could be applied in a world of ‘time of use’ tariffs where there could be up to 48 different prices during the course of the day, prices may vary between days, and in peak hours households might be exposed to high/very high prices to incentivise them to shift their demand to other times of day.<sup>44</sup> However as time of use tariffs are less attractive until there is widespread half-hourly settlement for residential consumers, which is still some way off, it is not clear how significant this issue will be prior to 2023.

### **11. What factors should be included in the determination of the cap?**

As discussed in our response to Question 6, the cap should be set in relation to the efficient cost of supply, but to provide room for competition to function, it seems reasonable to add a degree of ‘headroom’, so the cap is set somewhat above the estimated efficient cost of supply. In determining the efficient cost of supply, the CMA provides a sensible list of key factors to consider when setting a cap<sup>45</sup>. The factors relevant to the SVT cap are: (i) wholesale costs, (ii) network costs, (iii) policy costs (the costs of government policies), (iv) operating costs (the costs of an efficient supplier’s retail operations), and (v) headroom.

### **Impact of legislation**

### **12. What is the likely impact of the legislation on energy suppliers, the energy market and investment in the energy sector?**

If the cap works as intended, so the SVT price falls and competition in the rest of the market is not significantly softened, the cap would reduce the profitability of domestic energy retail businesses and the value of these businesses. The cap’s impact will not be equal across firms; the greatest impact will be on those firms with the highest proportion of their consumers on SVTs and who currently set their SVT price the furthest distance above the cap, probably the former incumbents, i.e. the Big-6. If the CMA’s analysis on efficiency is correct, even if the cap forces incumbent firms to exit the market, the change should be beneficial for consumers<sup>46</sup> as they will be supplied by more efficient firms that would charge lower prices. Ofgem has a resolution process in place for finding consumers of failing energy retailers a new supplier. However, if the cap were set in the wrong place so that it was below the actual efficient cost of supply this would be a significant issue.

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<sup>44</sup> If these prices were set in real-time, rather than in advance, there would be a further significant design challenge.

<sup>45</sup> See paragraph 39, pg 9-10, Competition and Markets Authority (2016c), ‘Energy Market Investigation, Draft Explanatory Note – Consultation: The Energy Market Investigation (Prepayment Charge Restriction) Order 2016’, available at: <https://assets.publishing.service.gov.uk/media/57fc99eb40f0b67138000002/energy-market-price-cap-explanatory-note-for-consultation.pdf>

<sup>46</sup> The job losses arising from an incumbent exiting the market, while detrimental for those concerned, are not generally considered an issue in modern regulatory decision making.

While one cannot be certain, the timing of SSE's announcement that it will separate its retail division from the rest of its operations and merge it with npower's retail business<sup>47</sup> seems likely to have been influenced, at least in part, by the increased likelihood that a cap will be imposed. Similarly, while British Gas has argued that its decision to end SVT contracts for new customers is not linked to the tariff cap<sup>48</sup>, this change is consistent with increasing the number of its customers who are not explicitly covered by the cap.

A cap should only affect the ability of the retail businesses of integrated supply companies to remain profitable/in the market. In aggregate there should be no substantive change in domestic energy demand and so the generation elements of these firms should be unaffected, with no additional risk of 'the lights going out'. Since the cap should not substantially alter energy demand, neither should it affect investment in generation capacity or the grid; reduced profitability should only affect investment in the retail section of the business. The proliferation of new entrants in the retail energy market suggests the need for capital investments in retail operations is not substantial.

The cap could affect the energy market as a whole, as noted in our responses to Questions 5, 6, 7, 13 and 14. Potential downside risks lead us to recommend strongly that the legislation describing the Ofgem review process explicitly requires assessment of any evidence that the cap is having substantial detrimental impacts; and that the legislation permits the SoS to terminate the cap if this outcome materialises (see our response to Question 4).

### **13. What is the likely impact of the cap on customer engagement and switching?**

The cap is likely to reduce the rate of switching relative to the level which would have occurred in its absence, since the cap is explicitly designed to reduce the price differential between FTTs and SVTs (see response to Question 5, above). The price differential between FTTs and SVTs represents a substantial proportion of the monetary savings available to SVT consumers when they consider switching supplier. A range of CCP research shows that increased monetary savings are associated with an increased probability of switching<sup>49</sup>.

For a rational consumer to switch supplier and gain benefit the expected gains from switching must exceed the expected costs. The expected gains from switching are mainly monetary, plus any improvements in customer service, after they have been suitably discounted to reflect a consumer's uncertainty about these gains being delivered. The expected cost of switching includes the opportunity cost of time spent searching for cheaper tariffs and completing a switch as well as contractual penalties, such as exit fees<sup>50</sup>. A similar trade-off between monetary and other benefits against the time required to switch applies to a consumer's decision to switch tariffs while remaining with their current supplier.

While we expect the tariff cap to reduce the switching rate, the switching rate itself is simply an 'intermediate objective' (see response to Question 5). The cap might be particularly detrimental if

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<sup>47</sup> See BBC News, 'SSE and Npower in energy merger talks' (*BBC News*, 7 November 2017), available at: <http://www.bbc.co.uk/news/business-41901335>

<sup>48</sup> See BBC News, 'British Gas scraps standard tariff for new customers', (*BBC News*, 20 November 2017), available at: <http://www.bbc.co.uk/news/business-42049562>

<sup>49</sup> Deller et al (2017b), Waddams Price and Zhu (2016a), Flores and Waddams Price (2013) and Giulietti, Waddams Price and Waterson (2005).

<sup>50</sup> Exit fees are only relevant for some customers with FTTs.

it induced currently active consumers to feel that they could 'relax' and not switch so often, since this would reduce the pricing pressure on FTTs.

The phrase "customer engagement" has different interpretations, and may include the decision to switch between one supplier's tariffs. In terms of a consumer's awareness of energy consumption, the sustained political and media debate around 'high' energy prices has probably increased consumer awareness and this may have encouraged some energy conservation. If the cap is effective, so that it lowers the price of a unit of energy for the majority of consumers and the political/media debate around energy reduces, there could be some increase in energy consumption and corresponding reduction in energy conservation activities by households.

#### **14. What evidence is there of the impact of tariff caps on prices, competition and switching in other countries or in the UK?**

In the UK, we draw attention to experience of the regional non-discrimination clauses imposed on the 'Big 6' between 2009 and 2012. These were introduced because, just as today, price discrimination between active and inactive consumers was regarded as a problem. Rather than price discriminate along the FTT vs SVT dimension, the former regional electricity incumbents set higher prices in their 'home' regions, where they had inherited customers as incumbents, than in the 'away' regions, where they were acting as new entrants. Active consumers who were willing to switch away from their incumbent supplier were charged prices on average 10% lower than the 'loyal' inactive consumers who did not. The regional non-discrimination clauses were designed to end this practice by banning 'undue discrimination', i.e. a basic relative cap was imposed on the prices charged by suppliers between their home regions and those where they were entrants.

Hviid and Waddams Price (2012)<sup>51</sup> predicted anti-competitive effects of these clauses. Waddams Price and Zhu (2016a) confirmed reduced competitive pressures immediately after the clauses were imposed; the CMA reported that both gross and net margins increased following the introduction of the non-discrimination clauses, and Ofgem found a deterioration in several competition indicators as part of its 2011 Retail Market Review. The negative impact of the non-discrimination clauses on competition is the main reason why we advise the government to avoid the use of basic relative cap.

As discussed in Question 6, as each firm had more customers on their high-priced (and high profit) 'home' tariff rather than their low-priced 'entry' tariffs the cap created an incentive for all firms to increase the price of their 'entry' tariffs towards the high-priced home tariff. Since all the former electricity incumbents did this at the same time, it also substantially reduced the pricing pressure on British Gas, who, as the gas incumbent, followed a national pricing strategy at that time. With fewer low-priced deals in each regional market, the gains from switching away from the regional electricity incumbent were reduced, leading to less activity in the market and providing room for increases in the home tariff as well. It is through this process that the non-discrimination clauses not only led to 'entry' tariff prices increasing, but also reduced pressure on home tariffs. While the non-discrimination clauses succeeded in their narrow aim of reducing regional price discrimination, they may have led to *all* consumers paying higher prices than would otherwise have occurred. The evidence that non-discrimination clauses had harmed competition meant they were allowed to lapse in 2012.

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<sup>51</sup> Hviid, M. and Waddams Price C. (2012), 'Non-Discrimination Clauses in the Retail Energy Sector', *Economic Journal*, 122(August), pp. F236-F252; Waddams Price and Zhu (2016b), 'Non-discrimination Clauses: Their Effect on British Retail Energy Prices', *The Energy Journal*, Vol. 37 Issue 2, p111-132

As noted in the response to Question 6, the current energy market is somewhat different to when the non-discrimination clauses were imposed, due to there being many more energy suppliers in the market today (around 50) which reduces the likely negative impact from a relative cap. It is ironic that the 'introductory' FTT offers which have generated price differentials today were stimulated (and explicitly permitted by the regulator) when the non-discrimination clauses were introduced<sup>52</sup>.

See our response to Question 13 for CCP evidence on the link between the size of monetary savings and switching in the UK, and why a cap is therefore very likely to reduce switching, all else being equal.

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<sup>52</sup> See response to Ofgem's final consultation at <http://competitionpolicy.ac.uk/documents/8158338/8262567/2.+response-catherine-waddams-2.pdf/a9855ff1-b34c-496a-9011-fa428abf7ab0>

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