

# Inactive Customers and Unilateral Market Power: The CMA's Energy Market Investigation

The United Kingdom's Competition and Markets Authority (CMA) recently completed a lengthy and in-depth investigation into the effectiveness of competition in the electricity and gas markets in Great Britain (GB).<sup>1</sup> The key driver of the investigation was a concern that domestic energy prices were too high and profits of the six<sup>2</sup> large energy companies, which supply 90% of GB customers, were excessive. There was a perception that the large, in particular vertically integrated, energy firms adopted a “rockets and feathers” approach to pricing whereby their retail prices were deemed to respond immediately to wholesale price increases, but came down very slowly when wholesale prices fell.

The investigation found, however, that increases in energy suppliers' costs during 2009-14 were largely driven by increases in network, social, and environmental obligation costs. Wholesale costs had remained relatively flat over this period and profit margins had fallen sharply in 2010, when many of the six large firms had incurred losses, but profits rose steadily thereafter. Notwithstanding annual variations in profitability, the CMA found that the average EBIT<sup>3</sup> margins earned by the six large suppliers during the five year period exceeded what it considered the normal rate of return that would be expected in a competitive market. Furthermore, the wide range in prices paid by domestic customers and the low level of switching were found to give rise to an adverse effect on competition through what the CMA described as an “overarching feature of weak customer response which, in turn, gives suppliers a position of unilateral market power concerning their inactive customer base”.

In this article, we examine the key findings of the CMA's energy market investigation.

## FINDING OF EXCESS PROFITS IN THE RETAIL ENERGY MARKET

The CMA found that average EBIT margins for sales to domestic customers were 3.5% over the 2009-14 period, with the margins for gas (4.5%) higher than those for electricity (2.5%). This was compared with the CMA's assessment that a normal (competitive) rate of return on assets would equate to an EBIT margin of 1.25% for an efficient retail energy company. An EBIT margin of 1.25% is significantly lower than margins approved by regulators in the UK and other jurisdictions including the competitive EBIT margin range of between 3-8.9% reported in the GB energy market

<sup>1</sup>“Energy market investigation: Final report,” Competition and Markets Authority, 24 June, 2016.

<https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf>

<sup>2</sup> Centrica, EDF Energy, E.ON, RWE, Scottish Power, and Scottish and Southern.

<sup>3</sup> EBIT refers to companies' earnings before payments of interest and tax or gross profit less indirect costs.

regulator Ofgem's 2011 Retail Market Review.<sup>4</sup> Ofgem considered a range of non-energy retail and utility sectors as part of its analysis of the competitive margin for energy retail and found that the average EBIT margin of 4.2% for retail energy companies in 2010 was lower than the EBIT margins earned by supermarkets, high street retailers and telecoms companies of around 5%, 7% and 10%, respectively. Research submitted separately by the six large firms to the CMA showed that EBIT margins in retail businesses range between 2% and 14%<sup>5</sup>. The CMA's focus on average EBIT margins across the six suppliers also obscured the significant range in margins between the six suppliers, as well as year-on-year variance in profitability. The investigation showed that at least two of the six large energy firms made losses over the selected period. The CMA did not focus on the differences in profitability between the six large firms, creating the misleading impression that all six firms made excess profits over the selected period, when in reality, just four of the six firms were in that position.

## SOME FIRMS HAVE UNILATERAL MARKET POWER

On the demand side, the CMA investigated what it saw as unacceptably low levels of customer engagement and switching, despite there being significant potential switching gains. Under the CMA's most aggressive scenario in which consumers would be willing to switch to the cheapest available offer, the gains from switching were found to average £164 a year for customers of the six large energy firms, and £143 a year for customers of mid-tier suppliers. This assumed that customers would be willing to switch to any supplier, without regard to their preferences over tariff type [single fuel or dual fuel (gas and electricity), fixed price, and duration or longer-term variable price tariffs linked to wholesale costs]. Neither were factors such as payment type (direct debit or prepayment, for example) or service quality considered. Average switching gains reduced significantly once consumer preferences were included in the analysis. Tariff comparisons were made between large suppliers' standard variable tariffs and mid-tier suppliers' one-year fixed tariffs offered for direct debit customers. The CMA did not consider whether mid-tier suppliers' prices, which are aimed primarily at customer acquisition, were sustainable in the long term even though none of the mid-tier suppliers were consistently profit making and some had posted significant year-on-year losses. Interestingly, the customers of the mid-tier suppliers could also achieve significant gains from switching if they were on a standard variable tariff.

The high number of inactive customers on standard variable tariffs led the CMA to conclude that the six large suppliers have a position of unilateral market power arising from the lack of customer engagement in the market, and that these suppliers have the ability to exploit such a position, for example through price discrimination or by pricing above competitive levels. The CMA's analysis did not, however, distinguish those suppliers with a largely inactive customer base from those that have a large share of engaged customers whom they have attracted through competitive offers. The overall effect was to treat all six large suppliers as if they behaved in the same way, despite evidence of significant differences in pricing strategies, market shares and ratios of active and inactive customers between them.

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<sup>4</sup> Ofgem RMR report published 21 March 2011, "Appendix 9 – Trends in profits and costs" of the report titled "The Retail Market Review – Findings and initial proposals, Supplementary appendices."

<sup>5</sup> CMA Energy Market Investigation: Provisional Findings, Appendix 10.6: "Retail profit margin comparators."

[https://assets.publishing.service.gov.uk/media/559fb6f4ed915d159500003c/Appendix\\_10.6\\_Retail\\_profit\\_margin\\_comparators.pdf](https://assets.publishing.service.gov.uk/media/559fb6f4ed915d159500003c/Appendix_10.6_Retail_profit_margin_comparators.pdf)

## CMA USED EFFICIENCY BENCHMARKING

In its Provisional Findings the CMA used three different methods for determining an efficient benchmark: the lowest quintile of the six large energy suppliers' costs; the costs of the two most efficient large suppliers; and efficient costs consistent with a 10% return on capital employed. Following criticisms of these benchmarks, the CMA changed its approach and just considered the costs of two mid-tier suppliers. Such an approach is not necessarily representative of the costs of new entrants or the wider peer group of all competitive suppliers. In particular, the selected companies are a smaller size, have different cost characteristics and business strategies compared to the six large energy firms, which calls into question their suitability for determining a competitive benchmark price.

## TRANSITIONAL PRICE-CAP FOR 4 MILLION CUSTOMERS

The CMA moved away from its initial intention of imposing a market-wide price cap on standard variable tariffs, to a more restricted transitional price cap for prepayment meter (PPM) customers, comprising around 4 million households, or 17% of the GB market. PPM tariffs are mostly used for customers with a history of bad debt who are often the most vulnerable. This was in response to widespread criticism from the industry, former regulators as well as new entrants that a market wide price cap would harm competition. A more restricted price cap will be less distortionary and better targeted to the most vulnerable customer group but it is nevertheless important that the methodology for determining the cap is robust and consistent with the CMA's objective to implement remedies proportionate to the estimated customer detriment to avoid distorting the market and restricting competition.

The key concern with the CMA's efficiency benchmarking, which underpins the level of the PPM price cap, is that it is not robust to systematic differences between the business strategies, scale and customer characteristics of the two selected mid-tier suppliers used to determine the level of the cap and the six large energy companies. Such differences are likely to bias the level of an "efficient" PPM price cap and could create market distortions. A more robust approach would be to select a wider peer group of companies and/or prices for determining the competitive benchmark. Such an approach would be more representative of competitive and sustainable prices.

## WHOLESALE MARKETS FOUND TO BE WORKING EFFECTIVELY

It is noteworthy that the CMA did not find any adverse effects in the wholesale energy markets. Initial theories of harm had included possible anticompetitive effects of vertical integration and a possible lack of liquidity in wholesale markets, both of which could deter entry or result in foreclosure. The investigation found no evidence that vertical integration was detrimental to the functioning of the wholesale energy markets or any evidence that new entrants were unable to tap liquidity. The CMA did find, however, that the absence of locational pricing for transmission losses and constraints, an issue that has been debated at length since privatization 25 years ago, could have a significant adverse effect on the nature of wholesale market competition in the future. However, as part of the remedies package, the CMA has imposed an order on National Grid requiring it to calculate generator imbalance charges (imbalances arise when a generator's production does not match its contractual position) which reflect regional variations in transmission losses.

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Dr. Bagci specializes in the economic analysis of competition. She has advised companies, financial institutions and regulators in connection with regulatory investigations of anticompetitive conduct heard before the European Commission and national regulatory authorities, including the UK CMA. She has assisted clients in connection with some of the most high profile regulatory investigations including the recent UK CMA investigations of competition in energy and retail banking markets. Other recent engagements include the determination of credit card interchange fees, alleged collusion and exclusionary conduct in the global CDS market and alleged manipulations of Libor, Euribor, FX and other financial benchmarks.



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