Competition and Price Controls in the UK Retail Energy Market

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In the late 1990s, the UK domestic (residential) energy market was opened up to retail competition. In 2002 Ofgem deemed the market sufficiently competitive to remove the final transitional price caps. Competition continued to develop. Many other countries followed suit.

However, in 2008, following a series of price increases, Ofgem expressed concern about competition and ‘unfair price differentials’. It introduced the first in a series of regulatory interventions. In June 2016 the Competition Authority confirmed that there was a competition problem in the retail energy market, and quantified the customer detriment at £2 billion in 2015. It found that earlier interventions had actually reduced competition, and recommended different interventions including a price cap on prepayment meter tariffs. In June 2017 most political parties including the Conservative party fought the election on manifestos that proposed to introduce more extensive retail price controls. At the time of writing, Ofgem has just proposed to extend the price cap to other vulnerable customers, but there is pressure to go much further.

There are conflicting views about the state of the UK retail energy market. Ofgem and the CMA have argued that ‘weak customer response’ has given the major suppliers market power, which they have used to set excessive prices and to discriminate against less engaged customers. This view, accepted and widely cited by Government and other political parties, sees the need for significant further intervention, including price controls, although views differ on the precise nature and scope of such price controls.

An alternative view, put forward or supported by several former energy regulators and various regulatory economists, is that increases in retail energy prices have reflected increases in underlying costs, and are not an indication of market power by retail suppliers. And price discrimination can be a reflection of competition rather than market power. Observed retail prices, price differentials and profits are thus not inconsistent with a competitive retail market. There may be a social or political concern about price differentials, especially involving vulnerable customers, but there is not a competition problem in the generally accepted sense of the term. Hence price controls are not called for, and are likely to make things worse.

The present paper summarises the evolution of UK policy and questions whether there is in fact a problem of market power.

1. Developing the Competitive Retail Market 1998-2008

In the UK (strictly, Great Britain), retail markets for electricity and natural gas were opened up to competition in several phases over the period 1990 to 1998, starting with the largest industrial customers and proceeding to the smaller commercial and domestic customers. The thinking was that retail competition would be more effective than a regulated monopoly in passing on to customers the benefits of competition in generation and wholesale markets. Competition would also provide greater stimulus to efficient purchasing and operations, and to innovative tariffs.

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Initially, transitional price caps were put in place in the domestic market. But competition developed quickly. By 2002, the 14 incumbent electricity suppliers had consolidated into five vertically integrated energy suppliers. But they had taken nearly 40 per cent of the gas market where the incumbent British Gas (Centrica) had previously held a monopoly. For its part, Centrica had become the largest electricity supplier, supplying 22 per cent of the domestic electricity market. Supplying both fuels (dual fuel) was a common means of competition. There were a few new entrants, but at that time they never took more than 1 per cent of the market in aggregate from the so-called Big 6 suppliers.

In 2002 Ofgem abolished the price caps because, as Ofgem’s Chairman and Chief Executive explained, ‘The evidence is overwhelming that competition is effective across all social groups and all methods of payment (BBC News, 15 February 2002). Competition could deliver more benefits for customers than regulation, and ‘ongoing price controls posed serious risks of braking or reversing the development of competition. These risks were judged to be the more serious if regulation were to be more tightly focused on prices paid by particular customer groups’ (Ofgem 2003, para 3.6).

At the same time, Ofgem announced a substantial programme of work to remove continuing obstacles to competition (associated with the transfer process, mis-selling, objections to switches etc). It sought to improve customer information and billing standards. And it extended its Social Action Plan to ensure that the benefits of competition are extended to all customers, including Prepayment Meter (PPM) customers, vulnerable customers, and the fuel poor’ (para 8.28). At that time, the suppliers voluntarily offered various ‘social tariffs’.

Ofgem also issued reports on the retail market. For example, Ofgem (2007) reported vigorous price competition for all customers; innovation by suppliers in terms of fixed and capped price deals, cheaper online deals and green tariffs; improving customer service; and customer switching rates at their highest in four years. On 16 January 2008, responding to Government and public concerns about recent energy price increases, Ofgem issued a press release headed ‘Market is sound – Ofgem assures Chancellor’.

2. Ofgem’s Probe and the Non-discrimination Condition 2008

One month later, on 21 February 2008, Ofgem launched a ‘probe into energy supply markets’, ‘to address mounting concern among customers that could undermine competition’. Its Probe Initial Findings (Ofgem 2008) did not find excessive profits: ‘assessment of suppliers’ profitability is difficult’ (p. 114). Nor did it find a reduction in competition: on the contrary, ‘there are now greater levels of competitive activity and consumer switching than in almost every other energy market in the world and most other UK consumer services markets. The fundamental structures of a competitive market are in place, and the transition to effective competitive markets is well advanced and continuing’ (p. 5).

Ofgem’s concern was that relatively few customers were ‘proactively and confidently engaged in the energy market’ (p. 59). Their switching was not protecting the less active customer groups, including vulnerable customers, who were paying about £1 billion per year more than those on lower tariffs.

To remedy the situation, Ofgem proposed a package of 20 new measures to address these issues by ‘accelerating the transition’ to effective competitive markets. This package included actions to promote more active customer engagement (including by clearer information on customer bills, an annual statement to each customer, an annual prompt about switching, a programme to promote confidence in price comparison and switching sites, and a customer awareness programme) and to help consumers make well-informed choices (including by an easy-to-understand price metric and rules on suppliers’ sales and marketing activities). There were also actions to reduce barriers to entry and expansion (for example, via suppliers publishing segmental accounts and by improving market liquidity).

Ofgem’s particular concern was ‘unfair price differentials’. Its main example was that ‘the five former incumbent electricity suppliers charged electricity customers in their former monopoly areas an average of over 10 per cent higher prices than comparable ‘out-of-area’ customers’ (p. 8). Ofgem therefore proposed a non-discrimination condition, to ‘ensure that price differentials are objectively justified by cost differences’ (p. 15). Ofgem had previously (between 1999 and 2002) twice considered such a condition, but had rejected it on the grounds that it could reduce the incentive to compete for out-of-area customers and provide an incentive to raise out-of-area prices rather than reduce in-area prices.

Ofgem did note initially that, to hold total revenue constant, some prices would fall by around £550 million but that other prices would rise by the same amount. It said that ‘Although a rebalancing of this type would not reduce average prices paid by consumers it would disproportionately benefit vulnerable groups. It would also improve the prospects for new entrants and small suppliers because margins for the most price sensitive and active segments would improve to levels that may make market entry profitable’ (Ofgem 2008, para 8.79 p. 113). But the subsequent press release (R35 16 December 2008) headlined on ‘Ofgem probe has half a billion pounds in its sights for customers’.
3. Results of the Non-discrimination Condition

A number of economists were critical of the proposed non-discrimination condition. Professor Catherine Waddams (2009) said it was ‘likely to stifle competition’. Professor George Yarrow resigned from Ofgem’s governing board GEMA on the issue, later referring to the ‘professional consensus’ that the proposals would have ‘harmful consequences for consumers and for competition’ (Yarrow 2009). The former Director General of Fair Trading referred to this ‘bad policy’ that ‘stops important kinds of price competition’ (Vickers 2009).

Ofgem implemented the condition in September 2009 for a period of three years, promising ‘a thorough review of the impact’ before the condition terminated. In February 2012 Ofgem proposed to renew the condition for two years, but in the event allowed the condition to lapse, without a review of the impact but with a strong warning to suppliers not to resume differential pricing.

Economists, however, were interested in the impact. Green (2012) noted ‘a large increase in the level of the average bill at almost exactly the same time that companies started to reduce their cross-region differences’. Hvid and Waddams Price (2012) cited ‘the rising levels of both gross and net margins’ as evidence that prohibiting discrimination would increase prices. Waddams Price and Zhu (2016) noted a halving in the difference between the incumbent’s price and the best non-incumbent price and commented that this had reduced customer switching. They concluded that ‘the constraint on incumbent price increases has weakened’, and that ‘this is likely to have been at the ‘absolute’ expense of just those consumers whom the regulator sought to protect.’

The average customer switching rate between suppliers had steadily increased from about 15 per cent per year in 2003 to 20 per cent in 2008. Then it fell steadily to about 16 per cent in 2011. This fall seems mainly attributable to the non-discrimination condition, which reduced the price differentials that motivate switching.

Another factor was that, as part of its Probe remedies, Ofgem introduced stricter conditions on sales and marketing, which came into force in October 2009 and January 2010. In July 2011, one of the major suppliers abandoned doorstep selling, and within another year all had done so. This meant that suppliers had less ability to engage with customers in lower socio-economic groups. The average switching rate continued to fall, even more sharply, to just over 10 per cent in 2013.

4. Further Regulatory Interventions: Simpler Tariffs

A year after introducing its non-discrimination condition, Ofgem (2010) noted a 38 per cent increase in net retail profit margins and announced its intention to review again the effectiveness of competition in the retail energy market. Its Retail Market Review (RMR) found that the ‘unfair price differentials’ had reduced but little else had changed, and there was a deterioration insofar as customers were now less active. Ofgem (2011a) attributed the fall in switching to ‘complex pricing structures’ and ‘an increase in the number of tariffs available’. The latter seem in part to have been a response to Ofgem’s measures, insofar as the retail suppliers now looked for other ways to compete and to engage with customers, increasingly via the internet.

Ofgem concluded that ‘further radical actions are required’, the most significant of which was ‘to make it far easier for domestic consumers to compare prices and get a better deal’.

3.15 We intend to address confusion in the domestic market by a proposal to restrict the number of tariffs for standard evergreen products from each supplier to only one per payment method. We also propose to standardise the format of these tariffs across suppliers, with suppliers allowed to compete on a single ‘per unit’ price. Consumers would then be able to tell at a glance whether they can save money either by switching supplier or by moving to a new deal. This would be a major reform impacting the 75 per cent of customers currently on standard evergreen products. (p. 48)

Standard evergreen (or variable) tariffs typically had a fixed (or customer or standing) charge per month or per quarter, plus a unit charge per kWh consumed. With due notice, such tariffs could be changed at the supplier’s discretion (sometimes not for a few years, but more frequently if wholesale prices were moving significantly).

Ofgem (2011b) announced the implementation of various measures foreshadowed in the Probe Initial Findings. It would require suppliers to provide a price comparison guide and a Tariff Information Label. There were also proposals to improve bills, annual statements, contract renewal statements and price increase notifications. These were remarkably prescriptive, extending for example to the specification of wording and font sizes on customer bills. They expanded the standard supply licence by several hundred pages.

But the central proposal now was tariff simplification. Suppliers would be allowed to offer only one standard tariff per payment method; Ofgem would set a standardised (uniform) fixed charge for all standard tariffs.
tariffs, and suppliers would then compete on a single unit rate for each standard tariff. In addition, discounts and bundled products and services would be prohibited.

This degree of standardisation seemed extreme: it was dubbed Ofgem’s Procrustean Bed (Littlechild 2012a). After consultation, Ofgem (2012) abandoned its proposals, citing unspecified ‘concerns’ and ‘practical difficulties’.

Ofgem now proposed that each supplier should be limited to a maximum of four tariffs per fuel (natural gas and electric power) per payment method (direct debit, standard credit and prepayment). All tariffs were to have a simple two-part structure that is a standing charge and a single unit rate. The standing charge could be zero, but the unit rate could no longer vary with the level of consumption, so declining block tariffs were prohibited. Discounts were allowed only if expressed in pounds, not as percentages, and were later prohibited other than for dual fuel and online accounts. Customers on ‘dead tariffs’ – those no longer available to prospective new customers – were required to be moved to that supplier’s cheapest ‘live or open tariff’.

Some obvious concerns were expressed (Littlechild 2012b, 2014). It would mean the removal of tariff varieties that customers valued. In practice it would not make the choice situation much simpler: the ever-growing number of suppliers meant over 100 tariffs to compare (and with three payment methods and 14 regions that meant many thousands of tariffs nationally). And it was not at all clear that simplicity of tariffs was the main driver of customer engagement. Pollitt and Haney (2014) argued that ‘a once showcase example of residential electricity market competition is being undermined by increasingly misguided politically motivated interventions in the way the market operates’.

Another consequence was a burgeoning of proposals for other interventions. Some favoured requiring each supplier to put all its customers on its ‘best’ tariff. The Prime Minister surprised everyone at Parliamentary Question Time by saying that the Government proposed to require suppliers to put their customers on the best tariff in the market. An obvious problem with such suggestions was that they assumed that the ‘best’ tariff was unambiguous, and more importantly that the tariffs offered in the market would be unaffected by such obligations.

The consumer organisation, Which?, advocated a ‘petrol pricing’ approach whereby each supplier would be restricted to a single nationally uniform price per kWh, with no fixed charge. The former Prime Minister Sir John Major proposed a windfall tax on energy suppliers. The Labour Party leader and former Energy Secretary Ed Miliband proposed to freeze energy tariffs until after the next election. This later became part of Labour’s 2015 election manifesto. The Conservatives responded that ‘healthy competition, not short-term political intervention, is the best way to secure a good deal for consumers’.

With some modifications the simple tariff rules and other prescriptions finally came into effect by January 2014.

5. Some Consequences of the Simple Tariffs Rules

Ofgem’s website said that ‘the new rules strip away unnecessary complexity in tariff choices’. In practice, this meant that introductory discounts, ‘cash-back’ schemes and loyalty discounts were banned. So, too, were discounts for prompt payment. A new tariff that, for several months, price comparison websites deemed ‘the best offer in the market’ was prohibited because the discount was greater in the first year than in the second. Popular tariffs with no fixed charge were largely withdrawn because they involved a two-tiered unit rate (a declining block tariff) that was now prohibited.

One supplier had offered a ‘StayWarm’ tariff that gave customers over 60 years of age a fixed monthly bill regardless of how much energy the customer used (though the bill could be adjusted on a forward-looking basis depending on actual usage). Ofgem had highlighted it in 2001 as one of a small number of major initiatives by fuel companies to address the needs of the fuel poor. It was withdrawn because it could not be adjusted to meet Ofgem’s new conditions.

Predictably, when restricted to four tariffs, suppliers focused on the most popular, profitable and reliable products. Minority tariffs such as green tariffs were largely withdrawn. Innovation suffered, partly because certain tariff types (for example, with wholesale price tracker mechanisms) were prohibited, and also because introducing a risky new tariff required withdrawing one of the four tried and tested tariffs.

Ofgem’s rules required that suppliers alert customers to their best available variable tariff. And at the end of a fixed-period tariff, in the absence of active customer choice otherwise, suppliers had to transfer customers to their best available variable tariff. Suppliers therefore found it uneconomic to use variable tariffs as low price ‘acquisition tariffs’ for gaining new customers. Instead, the main suppliers each limited themselves to one standard variable tariff and to two or three fixed-price fixed-period tariffs, typically for 12, 18 and 24 months. The latter tariffs provided suppliers with flexibility over time but militated against longer term customer relationships.
6. The CMA Investigation

In November 2013 there was a change of chairman at GEMA (the Gas and Electricity Markets Authority, the parent body of Ofgem). The Government announced that Ofgem would work with the Office of Fair Trading (OFT) and the new Competition and Markets Authority (CMA) that was in process of being formed from the merger of the OFT and the Competition Commission (CC). Ofgem would work ‘in preparing a framework for the assessment of competition in energy markets and would then conduct that assessment’.

In March 2014 this joint State of the Market Assessment identified a number of features of the market that might have an adverse effect on competition. In June, Ofgem (2014) referred the sector for a market investigation by the CMA, identifying essentially the same five issues for examination, namely weak customer response, incumbency advantages, possible tacit coordination, vertical integration and barriers to entry and expansion.

The terms of reference focused on supply to domestic and micro-business customers. They allowed the CMA to investigate related features (such as industry code requirements, third party intermediaries, the regulatory framework, and ancillary goods and services such as bundling boiler services with energy supply). But they excluded supply to larger customers ‘because we have little evidence of harmful features on those markets’ (p. 14).

The CMA (2016) found that four of the five identified issues – incumbency, tacit coordination, vertical integration and barriers to entry and expansion – were not a problem. Nor were other important and sometimes controversial aspects of the UK energy market, such as the wholesale electricity and gas markets and the self-dispatch system in electricity.

The CMA identified ten features of the market that did give rise to an Adverse Effect on Competition (AEC). These were the absence of locational prices for transmission losses and constraints, the Government’s mechanisms for allocating Contracts for Differences (CFDs) related to renewables without using a competitive process, the inefficient allocation of costs in gas settlement, the absence of a firm plan for moving to half-hourly settlement in the domestic electricity market, aspects of industry code governance that limited innovation and pro-competitive change, and ‘an overarching feature of a lack of robustness and transparency in regulatory decision-making’. (This latter finding related to Ofgem’s statutory objectives, the absence of a mechanism for transparently addressing disagreements between Government and Ofgem, the lack of effective communication on the impact of government and regulatory policies on energy bills, and the lack of a regulatory requirement for clear reporting on generation and retail profitability.)

A seventh AEC was the Retail Market Review’s simple tariffs requirement. The CMA (2016, paras 171-175) explained at length why this had an Adverse Effect on Competition.

There are few, if any, signs that customer engagement is improving materially, either in terms of direct customer activity (eg switching, shopping around) or their experience and perception (eg views on tariff complexity). … [Suppliers withdrew] a number of tariffs and discounts and changing tariff structures, which may have made some customers worse off. … The RMR four-tariff rule limits the ability of suppliers to compete and innovate and provide products which may be beneficial to customers and competition. … [The RMR rules] dampen price competition by limiting the ability and incentives of suppliers to respond to competition by offering cheaper tariffs or discounts (which means that they, in turn, put less competitive pressure on their rivals.

The CMA recommended that Ofgem remove its simple tariffs restrictions.

The remaining three Adverse Effects on Competition were associated with ‘weak customer response which, in turn, gives suppliers a position of unilateral market power concerning their inactive customer base which they are able to exploit through their pricing policies or otherwise’. The CMA found this weak customer response in both the domestic market and in the micro-business market. The CMA also found that technical constraints, higher costs and other issues had accentuated the problem of weak customer response in the domestic prepayment market.

It proposed a temporary price cap on prepayment meter tariffs until smart metering removed the technical constraints. It required suppliers to microbusinesses to make clearer their contract prices and termination arrangements.

Discussion of the CMA report mainly focused on its analysis of weak customer response and associated customer detriment, and its proposed remedies.

7. Weak Customer Response, Customer Detriment and Remedies

In assessing market power, the CMA put relatively little emphasis on the many new suppliers entering the market after 2008. By the end of 2013 their aggregate domestic market share had reached 5 per cent and half of all customer switches were to such new suppliers (Ofgem 2014, Figs 1, 2). By end 2016 there were some 50 new entrants in total, and their market share exceeded 15 per cent. Presumably the recovery of positive profit margins after 2008 made new entry more attractive, though entrants also had...
the benefit of exemption from significant environmental and social policy costs until they acquired 250,000 customers. Either way, new entry was a reality, and the Big 6 suppliers (whom the CMA called the Six Large Energy Suppliers) were under increasing pressure and (in aggregate) steadily losing market share.

Rather, the CMA focused on customer engagement. Its survey of domestic customers suggested to it that substantial numbers of customers were disengaged from retail energy markets. For a dual fuel energy customer of the Six Large Energy Suppliers, the saving from changing to the best tariff (under the most liberal scenario, potentially changing supplier, tariff and payment method) averaged £164 per year over the period Q1 2012–Q2 2015. This increased during this period to the equivalent of £330 in Q2 2015 (CMA 2016, pp. 31-32). Furthermore,

The survey results also suggest that those who have low incomes, have low qualifications, are living in rented accommodation or who are above 65 are less likely to be engaged in the domestic retail energy markets. (p. 33)

The CMA deduced that limited customer engagement was not because saving money was unimportant, but because of other factors: the lack of quality differentiation of gas and electricity supply, the lack of visibility of conventional meters, actual and perceived barriers to accessing and assessing information, and for some customers problematic experiences in searching for and switching suppliers. The CMA concluded as follows.

Overall, our view is that the overarching feature of weak customer response gives suppliers a position of unilateral market power concerning their inactive customer base and that suppliers have the ability to exploit such a position through their pricing policies: through price discrimination by pricing their standard variable tariffs materially above a level that can be justified by cost differences from their non-standard tariffs; and/or by pricing above a level that is justified by the costs incurred in operating an efficient domestic retail supply business. (p. 39)

Using its so-called ‘direct approach’, the CMA calculated that the average customer detriment averaged £1.4 billion per year over 2012-2015, and reached £2 billion in 2015.

To remedy this detriment, the CMA recommended that Ofgem should experiment with different ways of promoting greater customer engagement. It should also establish a Disengaged Customer Database: the six large suppliers would have to give Ofgem the contact details of those of their customers that had been on standard variable tariffs for more than three years, and Ofgem would then make these details available to other interested suppliers. Price Comparison Websites should also be enabled to compete more effectively by being able to offer tariffs not available elsewhere.

In its Provisional Conclusions, the CMA had considered a wide range of remedies, in the light of extensive consultation responses. It explicitly rejected the possibility of extending a price cap to all standard variable tariffs. (This would have extended coverage of the price cap from nearly one sixth to about two thirds of GB customers.) In its Final Report, the CMA majority reaffirmed this view:

... attempting to control outcomes for the substantial majority of customers would – even during a transitional period – undermine the competitive process, potentially resulting in worse outcomes for customers in the long run. This risk might occur through a combination of reducing the incentives of customers to engage, reducing the incentives of suppliers to compete, and an increase in regulatory risk. (p. 656)

In a dissenting view on this particular issue, one CMA member (Professor Martin Cave) argued that the proposed remedies did not go far enough.

The harm which is presently inflicted on households in this market (£2 billion in 2015, or an average of £75 for every British household) is very severe, and in my opinion how far and how fast that harm is reduced is the key indicator of the success of the household market remedies. But the remedies proposed for the large majority of households will take some time to come into effect, and are in any case untried and untested. (p. 1415)

Cave said that, over the previous three years, a wide variety of information remedies and other pressures had been tried and ‘had not made a dent’ in the proportion of customers on standard variable tariffs. Cave therefore proposed to supplement the engagement remedies with a price cap on standard variable tariffs for a temporary period, say two years, to remove a significant part of the 2015 detriment of £2 billion.

8. Developments on the Political Scene

At a Select Committee hearing on 10 January 2017, the Secretary of State commented that £1.4 billion annual detriment to customers ‘is clearly a huge amount of money’. He wondered ‘whether the pro-switching recommendations, which may be important, are sufficient to deal with the detriment that is being suffered by those people who don’t switch’.

In February and March, all but one of the large suppliers announced price increases. A cross-party group of MPs, arguing for stronger action than the CMA remedies, secured a debate in the House of Commons on 16 March. The Motion indicates their strong feelings:
That this House deplores the big six energy firms’ treatment of out-of-contract energy customers on default tariffs; believes immediate action is needed to protect those consumers, and that pushing customers to start switching will not fix the problem sufficiently quickly or completely on its own; and calls on the industry, regulators and the Government to consider solutions which recognise that many people lead busy lives and that switching their energy supplier may not always be a high priority.

John Penrose MP, supported by some small suppliers, argued for a relative rather than an absolute price cap, constraining the difference between each supplier’s highest and lowest tariff.

In April 2017 the Prime Minister declared a general election, indicating an intention to deal with ‘rip-off energy tariffs’. She would be ‘introducing a cap on unfair energy price rises. It will protect around 17 million families on standard variable tariffs’ and ‘save families on poor value tariffs as much as £100’ (The Sun, 9 May 2017). The Conservative manifesto promised ‘a safeguard tariff cap that will extend the price protection currently in place for some vulnerable customers to more customers on the poorest value tariffs’.

The Labour manifesto noted that the CMA had ‘found customers are overcharged an enormous £2 billion every year’. It proposed an immediate energy price cap to keep average dual fuel bills below £1000 per year, and an intention to take energy back into public ownership in stages. The Scottish National Party supported an energy price cap on standard variable tariffs. The Green Party supported public ownership. UKIP proposed to review ownership and profits of British utilities. In total, parties proposed over a dozen additional measures related to energy costs, efficiency, competition and protecting customers.

After the election, the Secretary of State asked Ofgem to advise him on what action Ofgem intended to take with respect to ‘safeguarding customers on the poorest value tariffs’ and ‘the future of standard variable tariffs’. Ofgem replied (3 July 2017) that it would examine ‘measures to protect and empower vulnerable customers’ and ‘look at options including extending the current safeguard tariff’. John Penrose MP complained that ‘some 17 million families are being ripped off by expensive standard variable tariff deals. Ofgem’s proposals will deal with at most 3 million of them, leaving 14 million still be preyed on by the big six energy firms’ (Hansard, Vol 626, col 891, 3 July 2017). The Secretary of State responded that Ofgem’s ‘initial proposal’ was ‘a step in the right direction’ but, if it did not sufficiently eradicate the consumer detriment identified by the CMA, he remained prepared to legislate.

9. Ofgem’s Treatment of Price Increases and Profitability

How did the UK transition from removing price controls in an apparently competitive retail energy market to reimposing price controls in an apparently uncompetitive market? Is there an alternative perspective and analysis of the situation?

Consider the economic and political situation in 2008. Domestic energy prices in real terms had fallen steadily for two decades, from the early 1980s to the early 2000s, but then roughly doubled in the next four years (House of Commons Library 2014). The consumer body Energywatch (2007) argued that energy markets were failing consumers, that ‘Ofgem has been complacent at best and negligent at worst’, and that the OFT or the CC should step in. The Government expressed concern about mis-selling, vulnerable customers not switching, and charges for prepayment meters. On 16 January 2008, as noted, Ofgem assured the Chancellor that the market is sound. But on 5 February the Select Committee announced an investigation into Energy Prices, Fuel Poverty and Ofgem. On 21 February Ofgem announced its own investigation. The Select Committee endorsed the concerns expressed to it and recommended that Ofgem take numerous remedial actions, commenting that this ‘will, however, need Ofgem to demonstrate a rather greater sense of urgency than has been made apparent so far’.

Ofgem (2008) set the scene well, referring to the ‘unprecedented increases in world fuel prices which have flowed through into record increases in wholesale and retail gas and electricity prices. A typical household’s energy bills have more than doubled since early 2004 and many households are now struggling to pay their bills.’ Energy debt levels and disconnection rates were rising, along with ‘the rising cost of food, petrol, mortgages and other essentials’. ‘Vulnerable consumers and those in fuel poverty are particularly affected.’

However, the main text had just five pages (out of a 210 page document) of rather technical discussion of the link between wholesale and retail prices, plus an econometric Appendix. The document failed to drill home the message that the retail energy price increases reflected cost increases outside the retailers’ control, and were not due to a failure of retail energy markets, or to exploitation by the energy suppliers.

On the contrary, Ofgem left a suspicion that the retailers might be guilty. It ducked the question about excess profits, commenting that ‘assessment of supply companies’ aggregate profitability is fraught with difficulties’ (p. 98). After brief and inconclusive discussion of average retail margins it focused on detailed comparisons for different fuels, for in-area versus out-of-area consumers, for proactive, reactive
and inactive consumers, and for different payment methods, expressing concern about those types of consumers who paid the relatively high margins.

These were interesting results, relevant to some then-current concerns, but what was missing was the big picture: the overall absolute profitability – or lack of it – of the retail suppliers. Ofgem estimated the total net retail margins on electricity and gas supply combined, over all six large suppliers, at about (minus) £500 million in 2005, £100 million in 2006 and £300 million in 2007 (Figure 8.1 p. 100). So over this period of increasing prices, Ofgem believed that retail margins were increasing, but on average were slightly negative. Ofgem later revised its estimates downwards, to about (minus) £250 million in 2005, (minus) £170 million in 2006 and zero in 2007, an average loss of about £140 million per year (Ofgem 2010, Fig 2.1 p. 11). That is, Ofgem’s later figures indicate that the six large suppliers had not been operating at an excess profit for these three years, but in aggregate at a loss.

The CMA later observed that ‘Ofgem’s inability to address concerns about the Six Large Energy Firms’ profitability with the information they currently obtain …was a significant driver of the set of circumstances which ultimately led to those Ofgem policy interventions which … have led to AECs’ (CMA 2016, para 18.143).

10. Ofgem’s Analysis of Price Differentials

Another public concern was higher prices for customers that did not switch. Ofgem (2008) described price differentials that did not have a ‘cost justification’ as ‘unfair’. It regarded such price differentials as an indication that competition was not working effectively, and that suppliers were using market power to exploit less engaged customers. In those areas, it argued, ‘the transition to competitive markets now needs to be accelerated’ (p. 1).

Yet a substantial economic literature explained why price discrimination can indicate competition rather than market power. Differential mark-ups over cost can be optimal or more efficient (Vickers 1998 p. 179, Baldwin and Cave 1999 p. 209). Price discrimination can be a means of competing and of intensifying competition (Corts 1998, Shaffer and Zhang 2000). In some circumstances, firms have no choice: the pressure of competition can force them to discriminate, simply to survive (Baumol 2006).

The retail energy market appears to be such a case. Retail suppliers are driven by competition to reduce prices to the most active customers (to try to keep those customers most prepared to leave, and to try to attract replacement customers from other suppliers). These prices are driven down towards operating cost. So suppliers have to try to recover their overhead costs (as well as operating costs) from their less active customers. But all their tariffs are subject to competition because all customers can switch. Ofgem’s data just discussed indicate that, rather than discrimination being a means of exploiting market power to make excess profits, the six large suppliers in aggregate did not manage to recover their operating costs plus overhead costs for the three years 2005-2007.

This is not to deny that differential prices, particularly those that may impact on some vulnerable customers, may be a significant social or public interest concern. In 2008 Energywatch, the Select Committee and the Government certainly felt that they were. The large suppliers themselves had voluntarily offered social tariffs to vulnerable customers, until in 2010-11 the Government insisted these tariffs be replaced by its own Warm Homes Discount programme. A public interest concern may justly assist to some customers or some intervention in the market, though the potential adverse consequences of such intervention need to be acknowledged and assessed. But differential prices per se are not an indication of lack of competition, indeed quite the opposite.

11. Customer Detriment, Profitability and Excess Profit in the CMA Investigation

The CMA calculated that domestic energy customers suffered an annual detriment of £1.4 billion per year over 2012-2015, and £2 billion in 2015. This has been very widely cited and used as the main justification for price control. However, this was not a calculation of excess profit. In principle, the CMA’s calculation involved comparing the average prices charged by the Six Large Energy Firms with a competitive benchmark price which is based on the prices charged by the most competitive suppliers (CMA 2016 para 10.5). This benchmark was acknowledged to be ‘a hypothetical construct, a ‘supplier’ that is a combination of the suppliers that we have identified as being the most competitive in the markets’ (para 10.18 p 602). But it soon became apparent that the large and smaller suppliers were not directly comparable, and the CMA had to make a series of major adjustments to their prices.

The large suppliers argued strongly that the comparison had not been made on a like-for-like basis. It was argued that proper adjustments could more than wipe out the alleged customer detriment, and that the CMA’s final report made two significant new adjustments, which had not been subject to consultation and details of which were redacted (Oxera 2017). In the event, the CMA compared actual prices of the six large suppliers with the CMA’s guess at what just two of the much smaller mid-tier suppliers would charge if they were not exempt from costly environmental obligations and if they had reached an efficient scale and if they were in a
steady state and if they were not loss-making and if instead they were earning a normal return on capital. It was a comparison with a purely hypothetical more efficient alternative.

The estimated customer detriment averaging £1.4 billion per year was significantly greater than the aggregate domestic retail margin that the six large suppliers earned during this period (before any return on capital), which was of the order of £1 billion per year. The large suppliers were apparently imposing a customer detriment by not operating at a loss.

The CMA made a separate calculation of excess profit, as part of its ‘indirect’ approach. It calculated that the Six Large Suppliers’ total net revenues, less a normal profit assumed to be a 10 per cent return on capital, averaged £303 million per year over the period 2007-2014. As with its ‘direct’ approach, the CMA made numerous significant assumptions and modifications, which again were challenged by the suppliers. But even taken at face value, £303 million is much less than the cited £1.4 billion, and it amounts to only about £12 on a dual fuel bill of around £1000 per year.

Furthermore, the calculation does not allow for the fact that the more efficient suppliers will make a return above the cost of capital even in a competitive market. The CMA did not draw a distinction between ‘true’ excess profit deriving from a market price above ‘the competitive level’, and producer surplus associated with a more efficient supplier having lower costs than a less efficient supplier. Cost differentials and producer surplus are entirely consistent with a competitive market, and there were indeed significant differences in cost and profitability between the six large suppliers. For example:

- Over the period 2009-2012 the least efficient large supplier (EdF) had an average indirect cost per domestic customer that was twice that of the most efficient large supplier. (Littlechild 2017 p. 7, drawing on Ofgem et al (2014) Fig 50 and para 37)
- Over the period 2009-2014, the largest supplier Centrica accounted for no less than two thirds of total retail profits (EBIT: Earnings Before Interest and Tax). The two largest suppliers (Centrica and SSE) accounted for 95 per cent.
- Over the same period, two of the six large energy suppliers had profit margins (ratio of EBIT to revenue) in the range 5 per cent to 7 per cent, two had margins around 1.5 per cent, and two made losses. (Littlechild 2017 pp. 7-8, drawing on Segmental Statements of Six Large Suppliers per Ofgem website)

These differences between suppliers’ costs and profits mean that producer surplus must be a significant part of the ‘excess profit’. Furthermore, since two suppliers made average EBIT margins less than the 2 per cent that the CMA considered a reasonable competitive benchmark for such suppliers, and two others actually made losses over this period – and these EBIT margins are before deduction of any return on capital – their prices were evidently below their average costs. This suggests that the average price in the market over the period 2009-2014 was not above ‘the competitive level’, and was more likely below it. So ‘true’ excess profit was minimal, if it existed at all. And the profits associated with one or two suppliers cannot justify price caps applied indiscriminately to all of them.

12. The CMA on Cost Inefficiency and Price Discrimination

In trying to assess customer detriment, the CMA calculated ‘the extent to which suppliers have incurred costs inefficiently (that is, whether costs are higher than we estimate an efficient supplier would incur)’ (CMA 2016 para 2.164). As its base-case benchmark for the cost of an efficient supplier, it used the lower quartile indirect cost per customer of the six large suppliers. This gave an estimated average inefficiency cost of £290 million over 2007-2014.

The CMA then explained that its ‘indirect approach’ to estimating customer detriment involved adding its estimate of excess profit (average £303 million) to its estimate of inefficient costs (average £290 million) to give a total £593 million per year on average over 2007-2012. This is about half the average £1.4 billion level generated by the CMA’s ‘direct approach’. But it raises two (at least) fundamental questions.

First, although there is no doubt that some suppliers are less efficient than others, why has neither the CMA nor its forerunners used such a calculation of inefficient cost in assessing market power or ‘weak customer response’. More specifically:

- Since there will always be differences in costs between suppliers in a real competitive market, why should this be regarded as a customer detriment in the retail energy market?
- Why is weak customer response singled out as responsible for supplier inefficiency, ignoring other factors such as regulatory interventions that were found to have an adverse effect on competition or EdF’s largely public ownership?
- How is it that customer response was so weak that suppliers were not under pressure to be efficient, yet

1 See the annual Consolidated Segmental Statements available via links on the Ofgem website.
so strong that suppliers could not set prices above the competitive level and two suppliers made losses?

- Why has the capital market not functioned to discipline efficiency, regardless of the strength of customer response? Why do company managers and shareholders accept losses, or minimal margins of tens of million pounds, if a share of efficiency savings of £1 to £2 billion per year is available?

The second fundamental question is: What is the logic of adding ‘excess profit’ – which in the event was essentially producer surplus – and ‘inefficient cost’ to give an estimated customer detriment?

In simple terms, ‘the competitive level’ of price is determined by the intersection of the industry Supply and Demand curves (Littlechild 2017). Suppose there is a downward shift in the Supply curve to reflect a set of hypothetically more efficient suppliers. The ‘competitive level’ of price will now be lower. The benefit to customers can be expressed as the sum of the previous producer surplus and the new reduction in cost. In other words, the ‘indirect approach’ to calculating customer detriment is not an estimate of how far suppliers have actually increased price above the competitive level. It is an estimate of how prices could be lower in a different and hypothetically more efficient world.

As noted above, this is also what the CMA’s ‘direct approach’ turned out to be. It was an estimate of the benefits that would flow from hypothetically greater efficiency. Quite simply, the CMA’s calculations do not mean what they are generally and understandably taken to mean. These customer detriments averaging £1.4 billion a year, rising to £2 billion in 2015, were not an indication that retail prices were above the competitive level as normally understood, or that the large retail suppliers were making excess profits of that magnitude, or even at all.

At one point, the CMA itself acknowledged this, and pointed out an important implication for policy. ‘A large part of the detriment we have observed in the form of high prices is likely due to inefficiency rather than excess profits, such that if we were to eliminate the entirety of the detriment we have observed through a price cap it would create substantial losses for the sector as a whole’ (CMA 2016, para 11.90). Unfortunately this particular message was not widely heard.

If the six large suppliers were not making excess profits, this undermines the CMA’s finding on price discrimination. The CMA concluded that these suppliers were exercising unilateral market power ‘through price discrimination by pricing their standard variable tariffs materially above a level that can be justified by cost differences from their non-standard tariffs’ (p. 39). In effect, the CMA argued that those customers who engaged in the market were protected by competition, but those customers who did not engage were not protected.

There is no doubt that the large suppliers were pricing their standard variable tariffs with greater margins above variable cost than their non-standard tariffs. But they were doing this to try to cover their total costs including overheads while subject to competition, not least from new entrants. In aggregate, the large suppliers had no market power. Prices in general were not above the competitive level, and if anything were below. The less engaged customers, as well as the engaged customers, were protected by competition. Two of the large suppliers supposedly exercising unilateral market power through price discrimination made losses throughout the period under examination. As explained, price differentiation may raise public interest issues, especially in relation to vulnerable customers, but it does not indicate a lack of competition in the market.

13. Conclusion

Since 2008, Ofgem and the CMA have argued that the domestic retail energy market is not working properly because the less engaged customers are disadvantaged. They have blamed ‘weak customer response’, which the CMA additionally claimed was the cause of supplier inefficiency. Ofgem estimated that less engaged customers were being exploited to the tune of £0.5 billion in 2008, the CMA estimated that customers in general were overpaying by £2 billion in 2015. The CMA proposed various remedies to prompt more customer engagement, plus a temporary price cap on prepayment tariffs. It advised against a cap on all standard variable tariffs. However, the Government and many others have used the CMA findings to press for a much wider cap.

The alternative view presented here is that retail competition, when not restricted, has worked well. Significant price increases after the early 2000s reflected increases in underlying costs – wholesale costs, network costs and the costs of environmental and social policies – but not excessive retail profits. Retail margins are not above a competitive market level. Price differentiation has provided lower prices to active customers, reflecting significant competition, not a lack of it. Competition has also protected the less active customers, since prices are not in excess of suppliers’ costs in aggregate. Competition, not least from fast-growing new entrants, is putting pressure on the costs and prices of all suppliers.

The CMA’s conclusion that customers are being exploited by £2 billion a year has led public opinion to favour strong regulatory intervention. But the CMA calculation is based on a comparison with a hypothetically more efficient industry, not on excess profits. And while there is agreement that regulatory intervention has been counterproductive in the past
there is little recognition that it could be counterproductive in future, especially when profits are not excessive. There are better ways of assisting vulnerable customers: for example, by increasing or extending the Warm Homes Discount, by enabling other parties to advise vulnerable customers, and by giving suppliers more discretion to offer social tariffs. Nonetheless, the pressure continues for more extensive price controls.

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Critical Issues in Regulation – From the Journals

**Competition in Retail Electricity Markets: An Assessment of Ten Years of Dutch Experience**. Machiel Mulder and Bert Willems, Tilburg TILEC Discussion Paper, 15 June 2016.

This paper examines a decade of retail competition in the Dutch electricity market and discusses market structure, regulation, and market performance. The section headings are: Introduction; Literature Review; Regulation of the Dutch Electricity Market; Method and Data (method; data); Results (market structure; innovation in products; price comparison websites; pricing strategies and price dispersion; retail margins; pass through of wholesale cost; and consumers); and Conclusions. There is also a technical appendix.

The authors find there has been a proliferation of product variety, in particular by the introduction of quality-differentiated green-energy products. While product innovation could be a sign of a well-functioning market that caters to customer’s preferences, it can also indicate a strategic product differentiation aimed at lessening the strength of price competition.

The authors find that gross retail margins have remained high, especially for green products, although margins have been slightly downward trending. The authors conclude that high margins indicate that the green retail market is less competitive – retailers are able to capture the higher willingness-to-pay of consumers for green products. Retail margins in the Netherlands are compared with those in Norway.

The authors find that price dispersion across retailers for identical products remains high. They also find that price dispersion across products for a single retailer remains high.

The authors do not find evidence of asymmetric pass-through of wholesale costs into retail prices. This conclusion is based, in part, on the results of an error-correction multiple-regression analysis.

Overall, the authors find that the retail market has matured since competition was introduced. This conclusion is evidenced by fewer consumer complaints and higher switching rates. The authors conclude that a fairly intensive regulation of mature energy retail markets appears to be needed to create benefits for consumers.

There are 48 items in the reference list with year of publication ranging from 1977 to 2016; but is particularly clustered around the most recent years.


This article is about congestion management in liberalised power systems, where generation and transmission services are unbundled, but remain tightly interlinked. Congestion management in the transmission network is crucial for the efficiency of these inter-linkages. Different regulatory designs have been suggested, analysed and followed. One approach is uniform zonal pricing with re-dispatch. Another is nodal pricing.

The previous literature has focused on either the short-term efficiency of congestion management, or on specific issues of timing investments. In contrast, this paper presents a generalised and flexible economic modelling framework based on a decomposed inter-temporal equilibrium model including generation, transmission, and their inter-linkages.

The model covers short-run operation and long-run investments, and hence, allows the authors to analyse short-term and long-term efficiency of different congestion-management designs. These designs vary with respect to: the definition of market areas; the regulation and organisation of transmission system operators (TSOs); the way of managing congestion besides grid expansion; and the type of cross-border capacity allocation. The authors identify and isolate implicit frictions and sources of inefficiencies in the different regulatory designs, and provide a comparative analysis including benchmarking against a first-best welfare-optimal result.

To demonstrate the applicability of their framework, the authors calibrate and numerically solve the model for a detailed representation of the Central Western European (CWE) region, consisting of 70 nodes and 174 power lines. By analysing six different congestion-management designs until 2030, the authors’ model shows that, compared with the first-best benchmark (that is, nodal pricing), inefficiencies of up to 4.6 per cent arise. These inefficiencies are mainly driven by the approach of determining cross-border capacities, and by the coordination of transmission system operators’ activities.

There are 43 items in the reference list. Year of publication ranges from 1962 to 2016, with about one-half of the items being published since 2010, and another cluster around 2005 and 2006. Journals that are referenced most frequently are: *The Energy*
Journal; Energy Economics; and Journal of Regulatory Economics. There are also references to publications in operations research; linear programming and nonlinear programming.

This article can be accessed by subscription to the Journal of Regulatory Economics.


This article is about the US Federal Energy Regulatory Commission’s (FERC) regulatory procedures for natural gas pipelines; specifically its rate-refund policy. The authors seek to demonstrate that these procedures induce regulatory arbitrage that leads to economic distortions. Specifically, they seek to demonstrate that the rate-refund policy causes pipelines effectively to ‘extort’ ratepayers through the addition of economically inefficient capital investment, which they argue is akin to the ‘gold-plating’ of investments.

The authors estimate the potential magnitude of this arbitrage impact on ratepayers to be between US$400 million and US$700 million annually.

The authors contend that the presence of this arbitrage opportunity leads to underinvestment in pipeline capacity, which they see as counterintuitive. They also see it as negating one of the principal purposes of rate regulation. They further contend that the FERC could easily eliminate this regulatory arbitrage by setting the refund interest rate equal to the pipeline’s (as-filed) weighted average cost of capital.

There are sixteen items in the reference list; comprising fourteen journal articles and two books. Year of publication ranges from 1947 to 2012, with ten of the sixteen items being published in the 1960s or 1970s. There are several references to the Averch-Johnson literature.

The article can be accessed by subscription to the Journal of Regulatory Economics.


This article is about substitution between fixed, mobile and voice over internet protocol (VoIP) telephony, and is related to the experience of the European Union (EU). The authors claim that ‘substitution effects between different types of telephony is the cornerstone of market definition and … effective regulation’.

The authors employ a half-yearly dataset for 20 EU countries over 2008-2011. The data are derived from Analysys Mason and Eurostat. Dynamic panel data methods are used in the estimation. It is hypothesised that subscription volumes are driven by: current and lagged prices (own-price and substitute prices); the number of broadband connections; the number of fixed incumbents’ subscribers in the mobile market; and income per capita.

The authors state that the analysis demonstrates strong access substitution between fixed-lines and mobiles, which is in line with the previous literature. However, the authors were surprised to find only ‘indicative evidence’ of substitution between fixed-line access and VoIP. Short-run and long-run elasticities are estimated for own-price and cross-price effects across the three services. They also find a positive relationship between adoption of mobiles and income.

A number of policy implications are drawn from the results, including that ex ante access obligations may be redundant (to be assessed on a country-by-country basis). Consideration of targeted access obligations is also suggested. There are also observations on over-the-top (OTT) applications.

Headings in the article are: Introduction; Literature Review; Model Specification and Data; Empirical Results; Policy Implications and Discussion; Conclusion; Appendix; and References.

There are thirty two articles in the reference list with dates of publication ranging from 1970 to 2016 – most items are clustered around 2010-2014. There are several references to the econometric literature, and a large number of references to the applied literature including in the Journal of Regulatory Economics, Telecommunications Policy and Information Economics and Policy.

The article can be accessed by subscription to Telecommunications Policy.


According to this Report ‘letter mail still matters ... in spite of years of volume decline, mail has remained, for most international posts, a remarkably resilient and profitable line of business’. To understand why this is, the U.S. Postal Service’s Office of Inspector General, in collaboration with WIK-Consult, analysed thirteen international postal services. These were selected for: the variety of their regulatory frameworks; diversity of market environments; and the availability of their data.
The analysis found that, despite their disparate situations, eleven of them – Austria, Belgium, Finland, France, Italy, Netherlands, Norway, Portugal, Singapore, Switzerland, and the United Kingdom – achieved, on average, a positive annual profit margin for mail during the five years of analysis from 2011 to 2015. Australia Post was the only non-profitable postal service, and Deutsche Post DHL changed the way it reports mail profits. Not only was mail a profitable business for the eleven postal services, it was ‘a critical and material one’. From 2011 to 2015, mail generated on average over 60 per cent of their total profits.

The fortitude of mail derived from postal services’ ability to raise their revenue per mail-piece, lower their operating expenses, or both. External forces often boosted that ability. According to the Report, it is no coincidence that the best performers benefited from:

- Less restrictive legal and regulatory environments. The freedom to raise prices above the rate of inflation is one critical factor that allowed postal services to achieve and sustain profitability. Favourable labour and pension laws also helped.
- Government support. This support came in several forms, such as subsidies, debt relief, restructuring aids, tax credits, and transferring pension liabilities to the federal government.

Whether they enjoyed those benefits or not, postal services, when legally allowed, took a common approach to cutting costs. Common methods used in almost every country were: workforce reduction; automation of mail processing; shrinking the number of post offices; and streamlining of sorting and delivery. However, there were differences in the timing and scope.

Changing market conditions threatened the profitability of mail services in all thirteen countries, but also provided opportunities in the form of efficiency-promoting technology. By combining such efficiencies, cost-cutting measures, and price increases, postal services worldwide have been able to keep mail profitable. According to the Report, ‘even as the parcel market grows and posts prepare for a new future, mail remains essential to their financial viability’.

There is a comprehensive list of references containing thirty-nine items.

Open With Care: The Duopoly Model for the Transition to Competition in Long-Distance Passenger Railway Transportation, Juan Montero, Rodolfo Ramos and Andrea Giuricin, *Competition and Regulation in Network Industries*, 17, 3-4, December 2016, pp. 241-259.

This paper examines the duopoly model as a transitional phase from monopoly to competition in long-distance passenger rail transport. The authors believe that there are obstacles to the introduction of competition, and that it is possible to overcome some of these obstacles by granting a second licence. This allows ‘government to control the process’ and to ‘exclude opportunistic entry’ by those only wanting to enter high-volume and high-margin routes.

Obstacles to entry are considered under the following sub-headings: specific obstacles; barriers related to railway infrastructure; barriers generated by economies of density, scale and scope; barriers related to public finance; and other barriers.

The duopoly model is considered in relation to the economic literature and the experience in other industries where a duopoly model has been used (particularly telecommunications).

The authors review the experience in three countries; namely: South Korea; the United Kingdom; and Spain.

Assessment is considered under the following sub-headings: promote the creation of competition that would otherwise not be generated; newcomer selection; facilitating reform of the incumbent’s operations; competition and collusion; and other factors.

There are approximately thirty-five references included in footnotes.

The article can be accessed by subscription to *Competition and Regulation in Network Industries*.


This article is about European rail policy, with particular reference to the British experience. The author observes that, until 1991, European rail policy accepted that rail transport was a natural monopoly provided by a single vertically-integrated government-owned operation providing both infrastructure and train operations. Where the government imposed public-service obligations to provide unprofitable services or charge non-commercial fares, the government should compensate the railway business. Otherwise, the railway should operate on a commercial basis. Policy shifted towards the introduction of competition in the early 1990s. It was recognised that infrastructure was a natural
monopoly, but policy-makers argued that it was possible to have competition between alternative operators over the same rail infrastructure.

EU legislation requires complete open access for freight and international passenger operators, although some restriction is possible on the carriage of domestic passengers on these trains where this would damage services run under a public-service contract. In order to reduce the risk of discrimination, it requires a degree of separation of infrastructure from operations, with separation of decisions on track-access charges and capacity allocation from any train-operating business and separate accounts. It also requires an independent regulator to whom appeals can be made in the case of alleged discrimination. Only now is legislation underway which will require competitive tendering for public-service contracts (but with provision for continued direct award of contracts where this process can be justified to an independent authority) and open access for commercial domestic passenger services (subject again to possible limitation where these would compete with services operated under public-service contracts).

In 1988 Sweden separated rail infrastructure and operations into separate government-owned businesses, and most of Europe followed this lead. The alternative, which is still permitted, is for infrastructure and operations to be separate subsidiaries of the same holding business. This was the model adopted by Germany, Italy, Austria and France. It is argued by these railways that this permits more efficient planning of investment and use of rail capacity, although this must be done in a way which does not discriminate against other train operators.

While on-track competition between freight operators is now widespread in Europe, neither on-track competition nor competition for public-service contracts is currently required in the (domestic) passenger segment. However, competition for public-service contracts is now the norm in Sweden and is rapidly spreading in Germany. On-track competition is also growing with two operators on key routes in Italy, Sweden and Austria; and three operators on the most important route in the Czech Republic.

Britain has taken rail passenger market competition furthest. It no longer has a state-owned passenger operator. Virtually all services are operated by private businesses under franchises awarded by means of competitive tenders. But it also has growing experience of on-track competition as a result both of overlapping franchises and of new open-access competitors.

There are seven articles in the reference list, with dates of publication ranging from 2011 to 2016.


This Working Paper contains a comparative assessment of four methods of estimating expected inflation.

The four methods of estimating inflation expectations are considered in this comparative assessment are: the AER’s current method: ten-year estimates of expected inflation comprising of the RBA’s forecast CPI inflation rate one and two years ahead and the midpoint of the RBA target inflation band of two to three per cent from three to ten years ahead; the ten-year bond breakeven inflation rate (BBIR) implied by the difference between the yields to maturity on nominal and indexed CGS; the ten-year expected inflation rate implied from the prices of zero coupon inflation swaps; and survey-based estimates of inflation expectations over a ten-year horizon.

The second section of the Working Paper defines the criteria of assessment for ranking the alternative methods with respect to best estimates of expected inflation. The assessment is made on the basis of five criteria: relative congruence; robustness; transparency; replicability; and simplicity.

The third section assesses the AER’s current method as estimates of expected inflation.

The fourth section considers whether the BBIR method based on ten-year bonds is now likely to result in best estimates of expected inflation.

The fifth section considers zero coupon inflation swaps as estimates of expected inflation.

The sixth section evaluates the survey-based method as estimates of expected inflation.

The final section is a summary of findings and conclusion where a ranking of the methods is undertaken.

The Working Paper has a comprehensive reference list containing well in excess of one hundred items.


This paper addresses the consequences of anticompetitive regulation on product and labour markets through their effects on production prices and wages. The approach taken by the authors is built on two basic assumptions – monopolistic competition in the goods market (which determines the size of rents) and bargaining in the labour market (which determines the distribution of rents between the worker and business).
The econometric model proposed is based on a panel-data sample of 2,820 observations from fourteen OECD countries from 1987 to 2007, covering eighteen sectors including manufacturing and market services. The econometric model seeks to explain multi-factor productivity (MFP). Manufacturing industries, which are generally sheltered from foreign competition, or even from national competition, are more likely to have a lower MFP, due to having fewer incentives to improve efficiency.

The results suggest that nearly all countries, especially European ones, can expect significant gains in MFP over time from economic policies reforming anticompetitive regulations on product and labour markets.

The reference list contains ten items, with articles from the *Quarterly Journal of Economics*, *Review of Economics and Statistics* and several OECD working papers. The year of publication of these items ranges from 2006 to 2014.

This article can be accessed by subscription to the *American Economic Review*. 
Regulatory Decisions in Australia and New Zealand

Australia

Australian Competition and Consumer Commission (ACCC)

Consent to Variation of 2011 Hunter Valley Access Undertaking

On 29 June 2017 the ACCC announced its consent to the Australian Rail Track Corporation’s (ARTC’s) application to vary the 2011 Hunter Valley Access Undertaking, which regulates the rail network used to transport coal from the mines in the Hunter Valley to the Port of Newcastle for export. The ARTC’s term of operation is now extended to the end of 2021.

NBN Co Revenue Controls – Final Determination

On 23 June 2017 the ACCC released its Final Determination on revenue controls for 2015-16 for NBN Co. which is Available Here.

Water Monitoring Report 2015-16 Released


Broadband ‘Speed’ Testing – Call for Volunteers

On 16 June 2017 the ACCC made a call for volunteers to assist it with ‘speed’ testing of broadband – access the Media Release here.

Electricity Inquiry – Issues Paper

On 31 May 2017 the ACCC released an issues paper for its inquiry into retail electricity supply and prices in Queensland, New South Wales, Victoria, South Australia, Tasmania, and the ACT. Submissions are sought by the end of June. A final report is anticipated in June 2018.

Non-NBN High-speed Internet Services – Decision

On 26 May 2017 the ACCC released its decision on the regulation of high-speed internet services supplied by non-NBN fixed line networks. Read the final decision report.

Wholesale Domestic Mobile Roaming

On 5 May 2017 the ACCC released its draft decision proposing not to declare a wholesale domestic mobile roaming service. Submissions were required by 2 June 2017.

NBN Quarterly Report


Structural Separation Undertaking

On 27 April 2017 the ACCC announced that its report on Telstra’s continued compliance with its Structural Separation Undertaking had been tabled in Federal Parliament. Read the report.

Hunter Valley Access Undertaking – Draft Decision

On 20 April 2017 the ACCC issued a draft decision not to accept the Hunter Valley rail network access undertaking lodged by the Australian Rail Track Corporation. Submissions were sought by 12 May 2017.

Australian Competition Tribunal (ACT)

No Matters Listed

Australian Energy Market Commission (AEMC)

Market Bodies Forum – Memorandum of Understanding

On 7 June 2017 the AEMC released a tripartite memorandum of understanding (MOU) for the operation of the Market Bodies Forum which reports to the Council of Australian Governments Energy Council. Read the MOU.

Annual Market Performance Review 2016 – Final Report

On 16 May 2017 the AEMC published its annual market performance review final report for the period July 2015 to June 2016; following release of the draft report in March 2017. This is an annual review of the reliability, security and safety of the national electricity market.

Review of Regulatory Arrangements for Embedded Networks – Consultation Paper

Australian Energy Regulator (AER)

Tasmanian Electricity Distribution Network – 2017-18 Tariffs Approved

On 16 June 2017 the AER announced that it had approved the tariffs to apply in 2017-18 for the Tasmanian Electricity Distribution Network.

New South Wales Jemena Gas Distribution Network – 2017-18 Tariffs Approved

On 16 June 2017 the AER announced that it had approved the tariffs to apply in 2017-18 for the Jemena Gas Distribution Networks in New South Wales.

Market Bodies Forum Launched

On 7 June 2017 the AER announced the formation of a Market Bodies Forum, comprising the AER, the Australian Energy Markets Commission, and the Australian Energy Market Operator. Monitoring and ongoing transformation of the national electricity and gas markets will be guided by the forum.

Retail Energy Market Update Released

On 1 June 2017 the AER released its report for the third quarter of 2016-17. Read the report.

State of Energy Market Report Released

On 30 May 2017 the AER released its tenth annual report highlighting all changes across the energy sector. Read comments from the AER Chair.

Electricity Distribution Network Tariffs in 2017–18 Approved in Queensland, New South Wales, and South Australia


Decisions on TasNetworks, PowerLink and AusNet Electricity Network Charges Released

On 28 April 2017 the AER announced its final determinations for amounts recoverable from electricity customers, by the following service providers:

- TasNetworks – the next two years
- PowerLink – the next five years
- AusNet – the next five years

National Competition Council (NCC)

South Australian Water Infrastructure – Certification

On 22 May 2017, the National Competition Council announced the certification of South Australia’s water access regime, for a period of ten years. The decision is consistent with the NCC’s final recommendation.

Australian Capital Territory

Independent Competition and Regulation Commission (ICRC)

Regulated Water and Sewerage Prices 2018-2023 – Announced

On 14 June 2017 the ICRC announced the regulated water and sewerage prices for 2018-23 for Icon Water.

Standing Offer Prices for the Supply of Electricity to Small Customers – Final Decision

On 7 June 2017 the ICRC announced its final decision on standing offer prices for the supply of electricity to small customers. Read the report.

New South Wales

Independent Pricing and Regulatory Tribunal (IPART)

Wholesale Water and Sewerage Prices – Final Report

On 30 June 2017 the IPART released its final decisions for wholesale water and sewerage prices for Sydney Water and Hunter Water. Access the Media Release here.

Solar Feed-in Tariffs 2017-18 – Final Determination

On 23 June 2017 the IPART released the benchmark range for voluntary solar feed-in tariffs for 2017-18 of 11.6 to 14.6 cents per kilowatt hour (c/kWh). Read more about the tariffs.

WaterNSW’s Rural Bulk Water Services – Prices Announced

On 13 June 2017 the IPART announced its prices for WaterNSW’s Rural Bulk Water Services to apply from 1 July 2017.
Retail Electricity Market Monitoring – Submissions Sought

On 23 May 2017 the IPART announced it was seeking feedback by 30 June 2017 on its approach to monitoring the performance and competitiveness of the NSW retail electricity market. The 2017 report will be the third report since the IPART’s price regulation role was abolished, and a Draft Report is anticipated in September 2017.

Northern Territory
Utilities Commission

Port of Darwin – Final Draft Access Policy, Draft Decision and Draft Reporting Guidelines

On 24 May 2017 the Utilities Commission released for comment by 9 June 2017, the Final Draft Access Policy, the Draft Decision relating to that, and Draft Reporting Guidelines, regarding the Port of Darwin.

Queensland
Queensland Competition Authority (QCA)

Regulated Retail Electricity Prices for Regional Queensland in 2017–18 – Final Decision

On 31 May 2017 the QCA released its final decision on regulated retail electricity prices for regional Queensland in 2017-18.

Solar Feed-in Tariff for Regional Queensland – Final Report


South Australia
Essential Services Commission of South Australia (ESCOSA)

Network Restoration during Significant Weather Events – Review

On 23 June 2017 the ESCOSA released its reviews of Network Restoration during Significant Weather Events.

Inquiry into Licensing Arrangements for Generators in South Australia – Draft Report

On 8 May 2017 the ESCOSA released its Draft Report for the Inquiry into the licensing arrangements for generators in South Australia. A final decision is anticipated in July 2017.

Inquiry into South Australian Bulk Grain Export Supply Chain Costs

On 16 March 2017 the Treasurer provided the ESCOSA with Terms of Reference for an inquiry into the South Australian bulk grain supply chain costs. Submissions were required by 12 May 2017. Public consultation on the ESCOSA’s draft report will also occur in the second half of 2017.

Tasmania
Office of the Tasmanian Economic Regulator (OTTER)

Standing Offer Regulated Electricity Prices and Feed-In Tariffs to Apply from 1 July 2017

On 23 June 2017 the OTTER announced the standing offer electricity prices that Aurora Energy can charge and the feed-in tariffs (8.929c/kWh) to apply from 1 July 2017. See here and here.

Victoria
Essential Services Commission (ESC)

Review of Unaccounted for Gas Benchmarks

On 16 June 2017 the ESC announced receipt of submissions to the second stage of its review, which will involve consultation on the calculation of the UAFG benchmarks. A draft decision is anticipated in September and a final decision in December 2017.

Proposed Customer Service Code Changes

On 31 May 2017 the ESC released guidelines to assist the State’s water businesses in developing their approach to customers experiencing family violence. On 10 April 2017 the ESC released its Final Decision to develop customer service codes for water businesses that reflect its response to one of 227 recommendations from the Royal Commission into Family Violence. After 30 June 2018, the ESC will review whether all water businesses have family violence policies in place.

Payment Difficulty Framework – Draft Decision

On 9 May 2017 the ESC released a revised decision in response to stakeholder concerns about the first draft released in October 2016. Read the final report.
**Recommended Market Trials into Benefits of Solar and Batteries**

On 23 March 2017 the ESC released a final report into the network value of small scale solar units and other forms of distributed generation. Read the final report.

**Western Australia**

**Economic Regulation Authority (ERA)**

**Report on State’s Water Usage**

On 22 May 2017 the ERA released its 2015-16 Water, Sewerage and Irrigation Performance Report into significant change in the way the State’s water is sourced. Read the report.

**New Zealand**

**New Zealand Commerce Commission (CCNZ)**

**Proposed Lines Network Investment**

On 22 June 2017 the CCNZ released a process paper detailing its assessment of lines company Powerco’s application proposing price increases to meet the cost of its planned $1.32 billion investment in its electricity lines network. A draft decision will be released in November 2018 and a final decision is anticipated 29 March 2018.

**Study of Wholesale Broadband Price Pass-Through to Customers**

On 21 June 2017 the CCNZ released a study showing that 90 per cent of the recent reductions in Chorus’s regulated wholesale broadband prices have flowed through to consumers. Read more.

**Default Price-Quality Paths for Gas Pipeline Services – Final Decisions**


**Annual Telecommunications Monitoring Report**

On 18 May 2017 the CCNZ released its annual telecommunications monitoring report, which shows the industry continues to change rapidly. View the report.

**Related Party Transactions – Invitation to Discuss**

On 12 April 2017 the CCNZ released a paper seeking input on how to regulate transactions between energy networks and related businesses. Submissions were due by 10 May 2017, with a draft decision anticipated in August.

**Chorus Network Capacity – Review**

On 14 March 2017 the CCNZ released the final decision in its review of the non-price features of the Unbundled Bitstream Access (UBA) service. UBA enables retail telecommunications companies to provide internet services over Chorus’s copper network without installing their own equipment in exchanges. View the final decision.
Notes on Interesting Decisions

Blueprint for the Future Security of the National Electricity Market

On 9 June 2017 the Independent Review into the Future Security of the National Electricity Market released its Blueprint for the Future. As the Review Panel was chaired by the Chief Scientist, Dr Alan Finkel, it has become known as the Finkel Report. The other members of the Review Panel are Terry Effeney, Chloe Munro, Karen Moses and Mary O’Kane.

The Review Panel observes that Australia’s electricity system is in transition, and that ‘there is no going back from the massive industrial, technological and economic changes’ facing the electricity system. While no country is immune to the change, what distinguishes countries’ approaches to the transition is how well-prepared they are in ensuring a secure, reliable and affordable electricity system. Australia is at a critical turning point. Managed well, Australia will benefit from a secure and reliable energy future. Managed poorly, Australia’s energy future will be less secure, more unreliable and potentially very costly. Governments have made commitments to a lower emissions future, but the ‘pathway is blocked by uncertainty about how to get there’. Unless immediate action is taken, Australia risks ‘being left behind’. This Review Panel recommends a way forward. The Blueprint for the Future Security of the National Electricity Market focuses on four key outcomes for the National Electricity Market (NEM): increased security; future reliability; rewarding consumers; and lower emissions. These outcomes will be underpinned by the following three pillars: an orderly transition; better system planning; and stronger governance.

The Review Panel argues that Australia needs to increase system security and ensure future reliability in the NEM. Security and reliability have been compromised by poorly integrated variable renewable electricity generators, including wind and solar. This has coincided with the unplanned withdrawal of older coal and gas-fired generators. Security should be strengthened through Security Obligations for new generators, including regionally determined minimum system inertia levels. Similarly, reliability should be reinforced through a Generator Reliability Obligation implemented by the Australian Energy Market Commission (AEMC) and the Australian Energy Market Operator (AEMO) following improved regional reliability assessments. These obligations will require new generators to ensure that they can supply electricity when needed for the duration and capacity determined for each NEM region.

In the Review Panel’s view, the reliability of Australia’s future electricity system will be underpinned by an orderly transition that integrates energy and emissions reduction policy. All governments need to agree to an emissions reduction trajectory to give clarity about how Australia will meet its international commitments. This will require a credible and durable mechanism for driving clean energy investments to support a reliable electricity supply. Further, it argues that governments need to agree on, and implement, a mechanism as soon as possible. Continuing uncertainty is undermining investor confidence, which in turn undermines the reliable supply of electricity and increases costs to consumers.

This report recommends a Clean Energy Target as that mechanism. As part of the orderly transition, generators should also be required to provide three years’ notice of their intention to close. This will provide time for replacement capacity to be built and for affected communities to plan for change. The Review Panel recommends that AEMO should publish a register of expected closures to assist long-term investor planning. Better system planning should see AEMO having a stronger role in forming the future transmission network, including through the development of a NEM-wide integrated grid plan to inform future investment decisions. Significant investment decisions on interconnection between states should be made from a NEM-wide perspective, and in the context of a more distributed and complex energy system. Further, AEMO should develop a list of potential priority projects to enable efficient development of renewable energy zones across the NEM.

The transition presents significant opportunities to foster innovation. The deployment of new technologies and improved integration of variable renewable electricity generators needs to be supported by: better data; early testing of technology; cyber threat awareness; and workforce preparedness. As reliance on variable renewable electricity generators increases, the Review Panel believes that AEMO must have access to the best available weather impact and forecasting capabilities. Improved confidence, understanding and management of the NEM will be reinforced by greater data transparency, including a ‘data dashboard’ for power system information. Governments and the community will have better visibility of emerging risks through stronger governance. The Council of Australian Governments (COAG) Energy Council should agree on a strategic energy plan for the NEM, building on the recommendations of the Review Panel’s report, reflecting government priorities. A new Energy Security Board should drive implementation of this plan and coordinate whole-of-
system monitoring of security, reliability and planning across the functions of the market bodies.

The Review Panel also believes that faster rule-change processes, a better-funded regulator with enhanced market monitoring capabilities and an operator with a broader planning role will all help achieve better overall system outcomes. Further, it believes that gas plays an essential role in providing secure and reliable electricity for Australians. To help address problems caused by increasing prices and reduced availability, the Review Panel recommends that AEMO be given expanded visibility on gas contracts so that it can plan responses to shortages. It further suggests that governments should work with communities to encourage safe exploration and production, based on: best-available evidence; performance data; and appropriate financial rights for landholders.

Consumers are central to the transition. The Review Panel contends that more attention should be paid to how consumers can best be ‘rewarded’ for demand management and for the power they generate through distributed energy resources such as rooftop solar photovoltaic. When combined with improved energy efficiency, the Review Panel expects this to help reduce consumers’ electricity bills. While the future grid will be more distributed, its security and affordability will be strengthened through smarter grids, meter-data information and clear data-ownership rules to promote new ways of trading. This will include a demand-response mechanism.

The Review Panel expressed its confidence that adoption of the plan will ensure the optimal functioning of Australia’s electricity system into the future.


On 19 June 2017, the Productivity Commission (PC) publicly released its Inquiry Report on the Telecommunications Universal Services Obligation (TUSO). There are nine chapters and four appendices. Chapter 1 provides relevant background to the inquiry. Chapter 2 provides an overview of the evolution of telecommunications technologies; services and industry structure. Chapter 3 reviews and evaluates the current TUSO against a number of guiding principles. Chapter 4 identifies other government programs that are broadly designed to meet telecommunications universal service objectives. Chapter 5 examines the considerations that should frame a new telecommunications universal service policy objective. Chapter 6 assesses the extent to which the market and the National Broadband Network (NBN) might address the various dimensions of universal telecommunications services. Chapter 7 considers policy options to address any ‘gaps’ identified in chapter 6. Chapter 8 discusses the relative merits of alternative funding models for universal service policies in telecommunications. Chapter 9 canvases issues associated with transitional arrangements. Appendix A outlines the conduct of the inquiry, including consultations undertaken and submissions received. Appendix B provides further information on the NBN. Appendix C presents an overview of approaches to universal service policies for telecommunications in OECD countries. Appendix D touches on the relative affordability of NBN services.

The PC’s fundamental view is that, in a digital age, the voice-based TUSO (with a net present value of $3 billion over 20 years and consisting of basic telephone and payphone services) is anachronistic and costly. The PC recommends that is should be discontinued by 2020.

The PC believes that rapid developments in telecommunications technology are transforming people’s lives. The growing demand for ubiquitous digital connectivity provides a strong case for reform that reflects evolving policy, market and technological realities.

The PC believes that the sizable government investment in National Broadband Network (NBN) infrastructure will provide high-speed (voice-capable) broadband to all premises (on request) across Australia by 2020 — at a quality that is, for the most part, superior to what has been previously available. The PC expects that wholesale prices will be capped nationally and across its different technology platforms. As such, it contends that the NBN has been designed to narrow the city-country ‘digital gap’ with cross-subsidies from commercial to non-commercial services.

The PC believes that Australians are well served by mobile networks, with over 99 per cent of people having access to mobile telephony (and to a slightly lesser extent, broadband) where they live.

In the PC’s view, leveraging off the NBN and mobile networks will mean that the objective of universal service can be reframed to provide baseline (or minimum) broadband and voice services to all premises in Australia. This will occur once the NBN has concluded its deployment phase, having regard to the accessibility and affordability of these services. Increasingly, broadband will be the main medium for voice services. For the vast majority (more than 99 per cent) of premises, the TUSO will no longer be needed.

Current market trends and policy settings suggest that telecommunications services will continue to be affordable for most people. To the extent that there are any remaining gaps of availability, accessibility or
affordability, current trends and policy settings suggest to the PC that these are likely to be small and concentrated. The TUSO can therefore be terminated once the NBN is fully deployed and replaced by a set of targeted policy responses for premises (up to 90,000) in pockets of the NBN satellite footprint without adequate mobile coverage cohorts of users with particular needs.

The PC believes that programs to address these gaps should: be flexible; allow for community input; and facilitate informed consumer choice. The costing of these programs should be transparent and subject to competitive tendering where feasible. Further, it believes that the narrow scope and small scale of these programs tip the balance towards funding from general government revenue as opposed to an industry levy.

While transitioning to this new universal service framework is complex and will take a few years, the PC believes that the transition process needs to start immediately. The fundamental obstacle posed by the ‘opaque’ contract with Telstra, and the surrounding legislative architecture, should be addressed promptly and systematically.

The PC contends that the current pattern of disparate and siloed policy reviews and proposed legislative reform raise concerns for the coherence of policies to address universal service objectives. It contends that these policies must be carefully managed and coordinated.
Regulatory News

2017 ACCC/AER Regulatory Conference

The 2017 ACCC/AER Regulatory Conference will be held in Brisbane at the Hilton Hotel on Thursday 27 and Friday 28 July 2017. Details about the conference and how to register are available on the ACCC’s regulatory conference webpage.