UNEXPLAINED MYSTERIES OF THE ENERGY MARKET INVESTIGATION

By Mark Friend [1]

I. PUBLICATION OF THE CMA'S FINAL REPORT

The UK Competition and Markets Authority ("CMA")'s final report on the Energy Market Investigation was published on June 24, 2016, the last working day before the 24 month deadline for publication.[2] The timing was perhaps unfortunate, as it meant that media coverage for the report was largely non-existent, being overshadowed by the shock news of the Brexit referendum result. A conspiracy theorist might question whether the timing was deliberately chosen to avoid too much media scrutiny of a report that has been seen in some circles as a whitewash.[3] Indeed, that was precisely the thrust of a question put to the CMA inquiry chair, Roger Witcomb, by the chair of the Energy and Climate Change Select Committee, Angus Brendan MacNeil, on July 5, 2016. Mr Witcomb explained in response that the CMA felt that it would have been:

> inappropriate and possibly even more controversial to publish the report in the pre-referendum period, and so we found ourselves in the position where it couldn't be before 24 June and it couldn't be after 24 June, which made the

[1] Partner, Allen & Overy LLP. Allen & Overy advised ScottishPower in this investigation. All views expressed in this article are those of the author and do not necessarily reflect the views of Allen & Overy or any of its clients.
[2] See: https://www.gov.uk/government/news/cma-publishes-final-energy-market-reforms.
[3] See: *The Guardian* June 23, 2016, *CMA energy market report expected to whip up storm of criticism* https://www.theguardian.com/business/2016/jun/23/cma-energy-market-report-expected-criticism-overcharging-uk-consumers-big-six-suppliers.

decision quite easy.

Such media coverage as there was at the time, and that has appeared in the weeks following the report, has tended to focus on the headline customer detriment figure of £1.4 billion, being the average annual amount by which the CMA claims the Big 6 energy firms have been over-charging customers.[4] It is this figure which forms the central plank of the CMA's decision to opt for one of its most controversial remedies, a temporary price cap for pre-payment customers since, in the absence of a very large measure of customer detriment,[5] it is doubtful whether such an intrusive remedial intervention could be justified on proportionality grounds.

Although several of the CMA's recent market investigations have resulted in (judicial review) appeals to the Competition Appeal Tribunal ("CAT"), with varying degrees of success,[6] by 5:00 p.m. BST on August 24, 2016 the two-month deadline for an appeal had passed without any of the parties involved having chosen to challenge the CMA's findings. As a result, the CMA's customer detriment calculations and the analysis on which they are based have avoided judicial scrutiny. It is true that the Energy and Climate Change Committee has been examining the CMA's report and hearing evidence from some of the main protagonists, including representatives from the CMA itself, but that is no substitute for the level of forensic detail that one would typically encounter in judicial review proceedings before the CAT, which can sometimes resemble a full merits review. Although there are doubtless many in the industry who will be relieved at the absence of an appeal, in one sense this is unfortunate, as the CMA's detriment calculations leave many questions unanswered. Significant elements of the CMA's detriment calculations are not in the public domain, as the published version of the final report contains extensive redactions.[7] In the absence of full disclosure of the CMA's workings, there is no way of knowing how robust the analysis is. However, there are reasons to be cautious before accepting the CMA's conclusions at face value given certain analytical errors made by the CMA at earlier stages of the investigation, as explained below.

II. ORIGINS OF THE £1.4 BILLION DETRIMENT FIGURE

[4] See for example: *Utility Week*, June 24, 2016, *CMA final report: the industry reacts*: http://utilityweek.co.uk/news/cma-final-report-the-industry-reacts/1256162#.V9FGDSb2bqM; *Daily Telegraph*, July 23, 2016, *CMA's Roger Witcomb. energy inquiry 'ran the risk of being hijacked'*: http://www.telegraph.co.uk/business/2016/07/23/cmas-roger-witcomb-energy-inquiry-ran-the-risk-of-being-hijacked/.

[5] The CMA estimated the detriment suffered by prepayment customers to be £388 million: see final report, para 14.18.

[6] There were appeals in *Groceries*, *PPI*, *BAA*, *Aggregates* and *Private Healthcare*.

[7] In line with its standard practice, the CMA states at page 3 of the final report that it has excluded from the published version of the report "information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure)." Essentially these refer to (i) information the disclosure of which the CMA thinks would be contrary to the public interest, (ii) commercial information whose disclosure the CMA thinks might significantly harm the legitimate business interests of the undertaking to which it relates or information relating to the private affairs of an individual whose disclosure the CMA thinks might significantly harm the individual's interests, and (iii) the need to consider the extent to which the disclosure of information mentioned in (ii) above is necessary for the purposes for which the CMA is permitted to make the disclosure.

The £1.4 billion estimate of customer detriment appeared for the first time in the final report, without any prior consultation on certain key elements of the methodology used to arrive at that figure. The calculation was based on the so-called "direct" method: a comparison of the prices charged by the Big 6 suppliers with a "competitive benchmark price," constructed from the average prices of the two most competitive smaller (or "mid-tier") suppliers in the market, Ovo and First Utility. The CMA adjusted the prices of Ovo and First Utility to allow for a normal return on capital[8] and to reflect differences in suppliers' size and rate of growth. In addition, the CMA adjusted the data for cost differences which were considered to be largely outside suppliers' control (exogenous cost differences).[9] At an earlier stage in the investigation, with the publication of the provisional decision on remedies in March 2016, the CMA had estimated the level of customer detriment using the same "direct" method at £1.7 billion.[10] The CMA's detailed workings were made available to parties' legal and economic advisers by way of a confidentiality ring. This led to extensive criticism from some of the main parties' advisers, and by the time of the final report the CMA was forced to concede that this estimate needed to be revised as the comparison between the costs of the Big 6 and the two benchmark suppliers had not been carried out on a like-for-like basis. In particular, the CMA had failed to take into account that the cost bases of Ovo and First Utility were lower than those of their Big 6 competitors because, as small (but rapidly growing) suppliers, they did not have to bear the full costs of the various social and environmental schemes that were in operation during the period under consideration.[11] In the early years of their existence those suppliers would have been fully or partially exempted due to their lower customer numbers. In later years their rapid growth would have meant that, in any given year, their level of obligation would have been lower than for a company with a stable customer base, as the obligation costs per supplier were calculated on the basis of the supplier's customer numbers in the previous financial year.[12]

In its response to the provisional decision on remedies, it was argued by one of the Big 6 suppliers that correcting for this issue alone would reduce the scale of the customer detriment by around £1.3 billion, while additional adjustments to the actual costs of Ovo and First Utility to correct for other conceptual errors in the CMA's analysis would wipe out the detriment entirely.[13] In the final report, the CMA accepted the need to amend its detriment

[8] The CMA explained that the prices of Ovo and First Utility were adjusted to give a competitive benchmark price that was consistent with an EBIT margin of 1.25 percent. The CMA argued that this was the level of EBIT margin that a large stand-alone retail energy supplier should earn (on average) in order to deliver returns on capital employed ("ROCE") in line with its weighted average cost of capital ("WACC"): see final report, paras 10.29, 10.69. However, the use of ROCE as a measure of profitability in an asset-light business, such as energy supply, is controversial, with most of the Big 6 suppliers voicing strong objections as a matter of principle, and some (RWE, ScottishPower and E.ON) arguing that the high degree of volatility observed in the ROCE results from year to year meant that it was unreliable as a measure of profitability. See: final report, Appendix 9.10, paras 17-18.

[9] Final report, paras 10.13-10.14.

[10] See: https://www.gov.uk/government/news/cma-sets-out-energy-market-changes.

[11] There were seven social and environmental schemes in operation during 2012-2015: final report, Appendix 10.1, para 23.

[12] Final report, Appendix 10.1, para 28.

[13] ScottishPower response to the provisional decision on remedies at para 1.6, available at: https://assets.publishing.service.gov.uk/media/571a07e9e5274a2017000006/ScottishPower_response_to_PDR.pdf.

calculations to ensure a like for like comparison between the Big 6 and the benchmark comparators in relation to social and environmental costs,[14] albeit that the full scale of the adjustment and its impact on the level of detriment are not disclosed. What seems reasonably clear, however, is that the impact must have been substantial. How, therefore, did the CMA arrive at the figure of £1.4 billion in the final report? The answer is that it did so by making two further adjustments to the costs of Ovo and First Utility that had not featured at earlier stages in the investigation. Conveniently for the CMA, these appear to have had largely the opposite effect to the adjustment made to account for differences between the Big 6 and the two benchmark comparator firms in relation to social and environmental costs. Again, the details are redacted, so one cannot be sure what the CMA has done. A cynical observer could be forgiven for wondering whether there was perhaps an element of reverse engineering in the methodology used to derive such a large a detriment figure, so that the CMA could more easily justify its decision to impose a price cap. Absent an appeal to the CAT, we will never know as the CMA did not make its underlying calculations available even to parties' legal and economic advisers.

III. THE TWO LAST-MINUTE ADJUSTMENTS

The first adjustment related to the treatment of the customer acquisition costs of Ovo and First Utility. Because both these suppliers were rapidly growing their customer bases, the CMA argued that their profits would have been artificially depressed, as the costs would have been incurred at the point of acquisition, but the income from those customers would largely be earned in future years. In order to correct for this, the CMA decided to amortise the costs over a six year period, arguing that six years corresponded to the average customer life seen in the industry as a whole.

The logic for amortising these up-front costs over some period does not seem unreasonable, but what is surprising is the choice of six years. One of the key findings of the CMA's investigation was that the market is characterised by weak customer engagement. This meant that large numbers of Big 6 customers were found to be paying relatively high "standard variable tariff" charges and failing to switch to more competitively priced fixed-term deals. But Ovo and First Utility are recent entrants to the market and have had to grow their customer base by targeting their offer at customers who are willing to switch (and who therefore do not suffer from the "disengagement" syndrome). It seems implausible that customers who have already switched to a new entrant will exhibit the same level of stickiness as the industry average, which will include many customers who have never switched. On that basis, it seems doubtful that the average life of an Ovo or First Utility customer will be anything approaching six years. The CMA does not disclose what assumption it has made about customer lifetimes. It notes that using a (redacted) shorter period would not make much difference to the calculation, but it is not clear whether the CMA had in mind

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The net effect of these adjustments would have been to translate the £1.7 billion detriment figure into a negative figure of around £700 million, indicating that Ovo and First Utility were operating below minimum efficient scale.

[14] Final report, Appendix 10.1, paras 24-28.

a period of (say) five years, or a much shorter period.[15] Potentially, the choice of the amortisation period could make a very substantial difference to the calculation.

The second adjustment related to the treatment of overhead costs. The CMA argued that Ovo and First Utility would have incurred infrastructure costs that reflected an expectation of future growth in customer numbers, and that as their customer base grew in future their overhead costs were likely to decline as a proportion of revenue.[16] Details of the adjustments made by the CMA are once again redacted, so it is not clear exactly what has been done. But it seems the CMA decided to assume overhead costs equal to a fixed percentage of revenues, based on the actual overhead costs already incurred by First Utility, and seemingly disregarding the actual costs incurred by Ovo, on the basis that they had been affected by factors that made them an unreliable benchmark.[17] Effectively, therefore, the CMA used the results of one single company as a benchmark comparator.

IV. CONCLUSION

The net impact of these two cost adjustments appears to cancel out the adjustment for social and environmental costs, allowing the CMA to conclude that the level of customer detriment was £1.4 billion. It is unfortunate, however, that the CMA has redacted core elements of its calculations, thereby preventing interested parties from being able to verify whether the results are robust. Media commentators may be willing to take the CMA's findings at face value, but absent any disclosure of the underlying workings even to parties' legal and economic advisers, this seems a highly unsatisfactory basis for politicians and regulators to make judgments about whether the prices charged by the Big 6 reveal evidence of an "over-charge."

[15] Final report, Appendix 10.1, para 31.
[16] Final report, Appendix 10.1, para 37.
[17] Final report, Appendix 10.1, para 38.