Silos Economics

Ofwat consultation on the 2025-26 Review of the Retail Exit Code (REC) protections

Submission by Silos Economics

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Introduction

Silos Economics provides economic analysis, expert testimony and strategic advice in the areas of competition and regulation. We want to help markets work better and deliver key benefits for society. This mission drives our intellectual endeavours and the work that we do, and shapes any shared initiatives that we may undertake with others.

We welcome Ofwat's review of the Retail Exit Code (REC) protections and the opportunity to contribute to this consultation. The views expressed here are those of Silos Economics alone, and do not necessarily represent the views of any of Silos Economics' clients.

Our submission focuses on whether price caps are needed in the business retail market, eight years after it was opened up to competition.

The remainder of this note is structured as follows. First, we provide our views on Ofwat's assessment on why price regulation is needed in the business retail market. Second, we explain why we consider that price caps should be removed and retailers should have full flexibility to set prices, subject to competition law. We include references at the end.

Ofwat's assessment of why price regulation is needed

In a market where competition is feasible and beneficial, it is generally the best tool to ensure good price outcomes for customers. While there can be issues around inefficient pricing, these can generally be tackled through competition law.

Price regulation is an exception in competitive markets. When used, it should be justified on a theory of harm explaining why competition is not capable of driving good price outcomes for customers, together with an assessment of why price regulation is an appropriate, effective and proportionate remedy to improve price outcomes for customers.

We consider that Ofwat's assessment of why price regulation is needed in the business retail market lacks a theory of harm supported by sufficient evidence. As such, it does not provide an economic rationale for this intervention. We outline our reasoning below.

Ofwat explains why price regulation remains justified in Chapter 4 of its consultation (Ofwat, 2025). It argues that price regulation is needed for Group 1 and Group 2 business customers - who together account for 85% of total market revenue (Ofwat, 2025, p. 12) - because "it remains the case that smaller customers are markedly less aware and engaged in the market and appear to have much weaker incentives to participate. Were price caps to be removed, we consider this would risk Retailers sustaining price levels above those expected where customers are more engaged, and competition is working more effectively" (Ofwat, 2025, p. 22).

Ofwat appears to rely on a theory of harm based on a weak customer response. This theory posits that there are barriers to customer engagement that hinder customers' ability to access, assess, and act on information. These barriers restrict customers from exercising effective choice and make them respond weakly to competitive offers, lessening competition and leading to poor customer outcomes.

A key concern with Ofwat's assessment is that it does not sufficiently demonstrate that such a theory of harm is credible in the context of the business retail market. While low engagement (e.g. low levels of switching or renegotiating) is a useful indicator, it is not, on its own, sufficient to validate or reject the theory of harm. Low engagement is consistent not only with the existence of barriers to customer engagement but also with their absence. Ofwat should have assessed the drivers of a weak customer response in the business retail market and provided supporting evidence. However, this assessment appears to be missing from the consultation.

Further, Ofwat does not explore whether factors unrelated to typical barriers to customer engagement may help explain low engagement. A relevant factor in this context is the price cap itself. As we explain in the next section, a price cap reduces price differentiation, which tends to reduce gains from switching and weakens incentives to switch. Ofwat finds that gains from switching are low (Ofwat, 2025, pp. 22, 24). Low switching rates could therefore be driven by low gains from switching arising from the cap, rather than by behavioural biases or other barriers to customer engagement (e.g. search and switching costs).

Finally, if the price cap itself affects incentives to engage, then observed customer engagement under the cap is of limited value in assessing how much customers would engage if the cap were lifted. This is a key concern in Ofwat's analytical approach.

In sum, Ofwat's assessment does not articulate a convincing explanation of why competition would not lead to good price outcomes in the business retail market. As a result, it does not establish the economic rationale for why price regulation is needed. Further, even if there were a weak customer response, the appropriate remedy would not necessarily be a price cap. Nonetheless, we have refrained from discussing potential remedies in this hypothetical case, since we have not seen a convincing assessment of why competition would not work well for business customers in the first place.

Why we consider price caps should be removed

We consider that price caps should be removed for all business customer groups. Retailers should have full flexibility to set prices, subject to competition law. This would foster competition in the business retail market and lead to better customer outcomes. We set out our reasoning below.

A price cap raises several risks for competition. First, it can lower the ability and incentives to enter the market or expand. If set too low, it can make cost recovery more difficult or reduce profitability, deterring entry. It can also constrain the ability to pass through increases in input costs to retail prices, increasing the risk of squeezed margins post-entry.

Second, it can dampen the ability and incentives to compete. An effective price cap constrains the ability to price differentiate and, therefore, the scope to undercut prices to win customers from competitors. It can also lessen the ability and incentive to innovate or advertise.

Third, as already mentioned above, a price cap can weaken customer incentives to engage. By reducing suppliers' ability to price differentiate, it tends to reduce gains from switching and, hence, incentives to switch (Waddams Price, 2018; Waddams Price and Zhu, 2016). Since it reduces price dispersion, customers may have lower incentives to search, become informed, and engage (Vickers, 2021; Armstrong, Vickers and Zhou, 2009). Price caps may end up increasing average prices by weakening customer engagement and lessening competitive pressure.

Evidence from the UK energy sector suggests that price caps can have an adverse effect on competition. The retail market for residential customers was opened up to competition in the late 1990s. A price cap was in place during a transition period until 2002, when it was removed (Littlechild, 2019). Competition intensified following that period (Waddams Price, 2018; Ofgem, 2007). In 2009 Ofgem introduced a relative price cap that constrained the ability of retailers to price differentiate between regions (Ofgem, 2009). The empirical literature suggests that this policy softened competition, halved customer switching, and increased average prices for customers (Waddams Price and Zhu, 2016; Hviid and Waddams Price, 2012). More recent evidence on price caps in the UK electricity sector highlights how they can introduce rigidities and impact exit. Three years after Ofgem introduced the price cap in energy retail for residential customers in 2019, the number of active suppliers went down from 62 to 26 according to Ofgem Retail Market Indicators. The price cap constrained suppliers' ability to pass through increases in wholesale prices in mid-2021 to retail prices and contributed to insolvency and exits. The price cap has also substantially reduced switching. According to Ofgem Retail Market Indicators, the total number of domestic electricity customers switching supplier decreased by 82% three years after the price cap was introduced.

Evidence from the water business retail market is consistent with competition risks from price caps having materialised. Around 85% or more of the market has been subject to price caps since the market opened up to competition in 2017. Price discounts below the price cap are low. The average best price offered by retailers compared to the REC default tariff was 5.6% for Group 1 customers and 4.0% - 4.7% for Group 2 customers in 2023-24 (Ofwat, 2024, p. 23). Customer savings are low. Annual savings made by customers that switched or renegotiated were 4% for Group 1 customers and 3.0% - 4.0% for Group 2 customers in 2023-24 (Ofwat, 2024, p. 23). Switching rates are low - around 3% for Group 1 customers and 6% for Group 2 customers (Ofwat, 2024, p. 13).

While Ofwat claims that "we do not see the REC price protections as a barrier to effective competition" (Ofwat, 2025, p. 26), the assessment above suggests otherwise. Further, since Ofwat relies on customer engagement as the key indicator to decide whether or not to remove the price caps - and this indicator is influenced by the cap - there is a risk that the price cap perpetuates itself over time, preventing retail business customers from reaping the full benefits of retail competition.

Price regulation was arguably justified at the start of market opening over a transition period - as it was in other UK utility markets that were opened up to competition in the 1990s. However, while well intended and aimed at protecting customers, it does not seem justified now. Ofwat has not put forward a compelling assessment of why price regulation is needed. Price caps are not used in other UK utility business retail markets. Further, while some UK regulators and competition authorities have found that some business customers (microbusinesses) may be affected by barriers to customer engagement (Ofgem, 2022; CMA, 2016), they have not recommended the use of price caps as a remedy to tackle any adverse effect on competition. Instead, remedies in these cases relate to demand-side remedies to mitigate barriers to customer engagement and measures to promote competition.

To sum up, since price caps raise substantial risks for competition and there is no compelling case for retaining them to protect business customers, our policy recommendation is to remove them and allow retailers to have full flexibility to set prices, subject to competition law. We consider this would enable the business retail market to work better and lead to better customer outcomes.

References

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