
Roadmap to a Flourishing Market - Appendix G

Theories of Harms

1. Background

The Competition Commission (forerunner of the Competition and Markets Authority (CMA)) established a set of guidelines¹ to be followed when investigating a market. The guidelines provided focus and structure for an assessment of the way competition is working in a particular market by defining one or more “theories of harm”. A theory of harm is a hypothesis of how harmful competitive effects might arise in a market and adversely affect customers.

It is important to note that a theory does not imply any pre-judgement of an adverse effect on competition, where certain market features may significantly prevent, restrict, or distort competition, ultimately leading to worse outcomes for customers.

Theories of harm should be developed through consultation with market participants and will not only form the basis for any issues that the investigation will address but also prompt participants to suggest remedies to them. The use of the theories is described in the CMA’s [Supplemental Guidance](#) on market investigations.

The Flourishing Market Roadmap is not a market study, and the Strategic Panel has not referred the Non-Household (NHH) Water Retailer Market to the CMA. The use of the CMA methodology in identifying theories of harm has been identified as best practice and in line with the approach with which regulated and competitive markets are familiar.

¹ [Guidelines for market investigations \(Apr 2013\)](#)

2. Examples of theories of harms

Retail Banking Market. In its investigation into the retail banking market in [2014](#), the CMA identified the three theories of harm which it believed could lead to poor outcomes for customers:

1. Impediments to customers' ability to effectively shop around, choose and switch products/suppliers;
2. Concentration giving rise to market power of some banks; and
3. Barriers to entry and expansion.

The CMA identified that there was an interrelationship between the different theories of harm: barriers to entry can lead to market power (theory of harm 2), and impediments to customer switching (theory of harm 1) can itself be a significant barrier.

Energy Market. The CMA published their results of their investigation into the UK Energy Market in 2016². They identified five theories of harms that had to be investigated to reach their conclusion:

1. The market rules and regulatory framework distort competition and lead to inefficiencies in wholesale electricity markets.
2. Market power in electricity generation leads to higher prices.
3. (3a) Opaque prices and low liquidity in wholesale electricity markets distort competition in retail and generation.
(3b) Vertically integrated electricity companies act to harm the competitive position of non-integrated firms to the detriment of the consumer, either by increasing the costs of non-integrated energy suppliers or reducing the sales of non-integrated generating companies.
4. Energy suppliers face weak incentives to compete on price and non-price factors in retail markets, due in particular to inactive customers, supplier behaviour and/or regulatory interventions.
5. The broader regulatory framework, including the current system of code governance, acts as a barrier to pro-competitive innovation and change.

Mobile Ecosystems market study. The CMA published their results of their investigation into the Mobile Ecosystems in June 2022. In this, they identified four theories of harms

²[Updated issues statement \(publishing.service.gov.uk\)](#)

1. There is weak competition within and between Apple and Google's mobile ecosystems, which can lead to consumer harm in the form of reduced innovation, lack of choice, and supra-competitive prices.
2. Consumers effectively face a binary choice between two mobile ecosystems – either Apple's or Google's, which limits their options.
3. There are significant barriers to entry and expansion for other companies due to the strong network effects and control of the ecosystem by the incumbents.
4. The control exerted by Apple and Google over their ecosystems affects app developers, potentially leading to higher costs and less innovation.

3. The Decker Report

Dr Christopher Decker's report ³ of Aug 22, conducted an analysis into:

- The differences between monopolistic and competitive industry structures.
- What needs to happen to facilitate a transition to competition.
- Insights for the transition to competition in the NHH water sector.
- The role of price regulation in the transition to competition.
- The use of "default" price regulation in competitive markets.
- Risks of default price regulation in markets transitioning to competition.
- An alternative way forward, including a transition plan or strategy

The report identified five specific harms:

1. Below cost default tariffs may lead to supplier exit. In situations where default tariffs are set below cost, or do not allow for a normal return, this can lead to supplier exit which can bring both immediate and long-term harm to customers
2. Pre-emptive/ ex ante regulatory intervention is an obstacle to competition. There is a need for the regulator to be willing to shift between the ex-ante preventative regulatory approach that is suitable for monopoly situations to a more flexible and ultimately re-active/ ex-post harm-based approach suitable for overseeing and supervising the development of competitive markets. Market dominance should be clearly defined and assessed. Dominant suppliers could then be subject to price regulation, while it is removed from nondominant suppliers.
3. Artificially low regulated prices may distort market outcomes. Ex ante price regulation is, in part, motivated by political considerations to keep water prices low. There is a need to consider and articulate the implications of this in the context of wider policy objectives for the sector such as system resilience and water conservation. There is a substantial body of research has shown that regulated water prices that are kept below market clearing levels can lead to under-investment and supplier financial difficulties, and can send the wrong economic signals to customers and, paradoxically, can be regressive in its outcomes.
4. Unplanned supplier exits impact customers. Harm will arise through the potential stranding of customers who may no longer have a supplier, or who incur costs in switching (either voluntarily or mandated) to another supplier.

³ [Accelerating the transition to competition in the English retail non-household water sector](#)

5. Lack of confidence generates stagnation. Customers may choose to “stay put” with their existing supplier and be less willing (or more reluctant) to switch supplier if they believe that there is a risk of future supplier exit.

As in the retail banking market there is an interrelationship between the different theories of harm as shown by the harm of the artificially low cost of water.

4. Theories of harms for Non-Household Water Retail Market

The Roadmap to a Flourishing Market workstream has used the approach of the CMA to propose seven potential theories of harm for the NHH market.

1. Market Power and Monopoly Behaviour. A single trading party or a small group of trading parties can influence prices, service quality, or choice. This theory examines whether dominant water retailers exploit their market power to the detriment of customers. It could also consider an assessment of the rationale for default price regulation within the competitive market
2. Lack of Effective Competition. If competition among water retailers is insufficient, customers may face limited choices, higher prices, or reduced service quality. This theory focuses on barriers to entry, lack of new entrants, and the absence of competitive pressure. It could also consider whether NHH customers are becoming dependent on the default tariff.
3. Inconsistent provision of information to customers. Customers may lack essential information about water tariffs, contract terms, or alternative suppliers. This theory explores situations where customers are unaware of better deals or fail to switch to more favourable options.
4. Risk Allocation and Risk Aversion. Water retailers face risks related to market dynamics, customer behaviour, and regulatory changes. This theory examines how risk allocation (e.g. demand reduction v retailer profit) affects retailers’ decisions & customer outcomes. It could also consider the impact on customers of unplanned exits by suppliers from the market.
5. Operational Efficiency and Cost Reduction. Inefficient water retailers may pass on higher costs to customers. This theory considers whether operational inefficiencies lead to poor customer/environmental outcomes.

6. Customer Engagement and Inertia. Customers who are passive or lack awareness may remain with their default retailer even when better options exist. This theory addresses the impact of customer inertia on market dynamics. It could also consider the impact of the default price cap on specific customer groups.
7. Market Complexity and Complexity Costs. Complex market structures, tariffs, and contractual terms can confuse customers. This theory explores how complexity affects customer decision-making and overall market efficiency.
8. Wholesaler Monopoly Power. Retailers' appetite for competition for customers may vary across regions. This theory explores the impact of wholesaler terms (e.g. payment terms, contracts, tariffs) on the retailers' appetite to manage customers in a region