Competition & Markets Authority

Modernising the Energy Market

24 June 2016

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1. We have now produced the final report of our energy market investigation, in which we set out the competition problems that we have identified in gas and electricity markets in Great Britain, and our remedies to them. This has been the most comprehensive and wide-ranging review of the energy market since privatisation and our final report is, necessarily, a long and detailed document. We have therefore produced this overview to set out the approach we have adopted in undertaking our investigation and to summarise our key findings.

The context for our investigation

2. Energy markets are vital to the economy and fundamental to the wellbeing and prosperity of households and businesses. Well-functioning energy markets must meet the twin objectives of ensuring a secure, reliable supply of energy and delivering affordable prices: energy costs are a major burden on domestic customers, **reaching almost 10% of overall expenditure for the poorest households**. And, increasingly, energy markets are required to meet a third key policy objective of reducing harmful greenhouse gas emissions: despite substantial reductions in recent years, the energy supply and residential heating sectors still comprise over 40% of all UK emissions.

3. The sector has experienced substantial and continued regulatory change over the period since full liberalisation of retail energy markets in 2002. New policies have been introduced to reduce greenhouse gas emissions, including the recent introduction of Contracts for Difference (CfDs) to support low carbon electricity generation, while other regulatory changes have been introduced to address perceived problems in the wholesale or retail markets, such as Ofgem's Retail Market Review (RMR) reforms.

> “Energy is almost 10% of overall expenditure for the poorest households

4. Ofgem referred the energy markets to us in 2014, a decision that can be seen as the culmination of concerns regarding the energy sector that had been growing for a number of years. Perhaps most importantly, there was a rapid increase in retail energy prices between 2004 and 2014: **average annual domestic gas prices rose by around 125% in real terms over the period, and domestic electricity prices by around 75%**. There was no consensus on the extent to which these price rises reflected increases in costs, which led to a concern that current price levels may be generating excessive levels of profitability for energy generators and suppliers.

5. At the time of the reference, the sector faced considerable challenges, including political uncertainty and a notable lack of trust between policy makers, energy companies and customers. A key reason for the reference was to "clear the air" through an independent, authoritative market investigation, by resolving key areas of disagreement and uncertainty, and beginning to restore trust. Given this context, we have had three key objectives in undertaking our investigation:

   a. To identify competition problems where they exist and address them with a robust package of remedies;

   b. To highlight those areas that have been the subject of public concern or political controversy but where we have not found problems, explaining why we consider intervention would not be justified; and

   c. To reduce instability by helping to build a robust regulatory regime for the future.

"New entrants now make up 13% of the domestic energy market in both gas and electricity

Our key findings

6. Our investigation has identified several aspects of the gas and electricity markets that are working well for customers. In the wholesale markets, which comprise about 50% of the overall costs of gas and electricity, we have found no evidence that companies are able to exploit market power, our analysis of wholesale electricity prices suggests they have been reflective of costs and there is no evidence of generators having made excessive profits over the period we reviewed. In the retail markets, the last few years have seen a sustained period of growth for new entrant suppliers outside of the Six Large Energy Firms, and **their combined market share now stands at around 13% in both gas and electricity** - the highest level reached since liberalisation.

7. We have also found that several areas of prior concern have not had a harmful effect on competition or customers. In particular, at the time of the reference there were widespread concerns about the anti-competitive effects of vertical integration, and calls for the Six Large Energy Firms to be broken up. In practice, we have not found that such concerns are supported by the evidence. Vertical integration confers at most a modest benefit on firms structured in this way, and independent generators and suppliers are able to compete effectively with such firms, as shown by the recent decisions of two of the Six Large Energy Firms substantially to separate their generation and supply businesses.

8. Our investigation has, however, identified substantial problems in the energy markets, which require significant intervention. The problems we have found fall into three main areas:

   a. the demand side of retail energy markets – in particular, **a lack of engagement in the markets on the part of many customers**, which suppliers are able to exploit by charging high prices;

   b. the supply side of both wholesale and retail energy markets – a combination of **regulations and technical constraints that restrict competition**, to the detriment of customers;

   c. the **broader regulatory framework** – the system for regulating the energy sector, which hinders the timely development of policies and regulations that would be in the interests of customers.

Low customer engagement

9. We have found that large numbers of domestic customers do not engage in retail energy markets by shopping around or switching supplier. **In our survey of 7,000 domestic customers, 34% of respondents said they had never considered switching supplier and 56% said they had never switched supplier, did not know if it was possible or did not know if they had done so.**

10. Reflecting this widespread lack of engagement, **around 70% of the customers of the Six Large Energy Firms currently pay the Standard Variable Tariff (SVT), which is the default tariff** (ie the tariff customers pay if they have not made an active choice), despite the fact that SVTs are much more expensive than alternative tariffs. For example, the dual fuel SVT customers of the Six Large Energy Firms (excluding prepayment customers, who, as noted below, have a very restricted range of tariffs) **could have made average annual savings of around £330 in mid-2015 if they had switched to another supplier.**

11. Regarding the relationship between prices and costs, we have found that, while the competitive acquisition tariffs offered by suppliers have tracked wholesale, network and policy costs quite closely, there has been a widening gap between the SVT and these costs in recent years. This reflects the ability of suppliers to exploit SVT customers' relatively low levels of engagement in the market to price the SVT above competitive levels.

12. Several suppliers and some commentators have argued that the fact that so many customers have not taken up the opportunity to save money by switching must mean that the savings available are not sufficiently important to them or that they attach value to factors that we have failed to account for, such as an inherent preference for the SVT or for the quality of service offered by their existing supplier.

13. We do not find these arguments convincing. We have not identified any characteristics of the SVT to which customers would attach significant value, particularly in comparison with cheaper fixed rate tariffs with no exit fees. Nor have we seen any evidence to suggest that suppliers offering the cheapest tariffs have worse quality of service than those offering more expensive tariffs. Further, our survey results suggest that those who are on low incomes are far less likely to have engaged than those on high incomes, which undermines the argument that most customers do not take up available savings because they are not significant enough.

14. We have considered the range of barriers to engagement that domestic customers may face. Some categories of customer – for example, those who do not have access to the internet, those who are on particular types of restricted meter, and prepayment customers – experience specific, material difficulties in shopping around and switching. However, for the majority of domestic customers, shopping around and switching is relatively easy - yet many of these customers have never considered engaging, either because it has not occurred to them or because they think it will be too much hassle. There are a number of possible explanations for this, including the role of traditional meters and bills, which create barriers to understanding, the lack of quality differentiation of gas and electricity and the absence of a trigger point for engagement, arising from the fact that energy is continuously supplied whether or not a customer has signed a contract.

> “In 2013, 45% of microbusinesses were on default tariffs

15. Weak customer engagement is also an issue for some microbusinesses – we note that, **in 2013, 45% of microbusinesses were on default electricity tariffs**. The most significant factor behind the relatively weak customer engagement of microbusinesses is a lack of price transparency concerning the tariffs that are available to them, since many tariffs are not published, but individually negotiated between customer and supplier.

Regulatory and technical constraints

16. We have also identified a number of problems affecting the supply side of the energy markets, which serve to restrict or distort competition to the detriment of customers. The issues that we have uncovered relate to regulations and technical issues that were not the subject of public debate prior to the reference – none of them was mentioned in Ofgem's reference of the energy markets to us, for example – but they are having a fundamentally harmful effect on customers, by increasing the prices they pay and restricting their choices. The problems fall into two broad categories:

- **a.** regulations and technical constraints that limit the scope of competition (the allocation of CfDs, constraints that restrict competition for prepayment customers, aspects of the RMR reforms); and
- **b.** regulations that insulate companies from certain costs, thereby dulling incentives to improve efficiency (charging for electricity transmission losses and the settlement systems for gas and electricity).

17. **CfDs** have recently been introduced to incentivise investment in low carbon generation, and CfD subsidy payments are due to reach about £2.5 billion a year by 2020/21. We believe that DECC's introduction of a competitive allocation process for CfDs in 2015 was a positive step towards ensuring an efficient allocation of support, but we are concerned that DECC retains the powers to allocate CfDs through a non-competitive allocation process in the future as this risks substantial increases in the costs borne by customers. We estimate that DECC's decision to allocate CfDs to several projects outside the competitive process in 2014 is likely to have resulted in customers paying far higher costs (approximately £250-310m per year for 15 years) than if the contracts had been awarded competitively.

> “70% of the customers of the Six Large Energy Firms are on default tariffs

18. Perhaps the starkest example of the competition problems we have identified concerns **customers on prepayment meters - around 16% of all domestic customers**
Prepayment meters are generally installed where a customer has had a poor payment history or in certain types of rented accommodation and, compared to the rest of the population, prepayment customers are more likely to: have low income; have low or no qualifications; have a disability; and live in social housing.
We have identified several problems affecting competition for customers on prepayment meters, including constraints arising from the dumb (ie non-smart) prepayment infrastructure, such as limitations on the numbers of tariffs that suppliers can offer due to the restricted availability of gas and electricity tariff 'slots'.

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> prepayment customers do not have access to the cheap tariffs available to direct debit customers

19. As a result of these and other constraints, competition to serve prepayment customers has been weak. Nearly all prepayment customers are on SVTs (which are more expensive than direct debit SVTs) and they do not have access to the cheap tariffs available to direct debit customers: **as of April 2016, there were very large differences between the cheapest prepayment and direct debit tariffs, between £260 and £320**, depending on the region.

20. We have found that other regulatory interventions have restricted competition for domestic customers more broadly, notably **Ofgem's RMR reforms**.
 The stated purpose of RMR was to promote customer engagement, but we have found that the 'simpler choices' component of the rules, which, amongst other things, restricts the number of tariffs suppliers can offer, and constrains the structure of the tariffs and cash discounts they provide, has led to firms withdrawing tariffs and discounts in a way that has made some categories of customers worse off and harmed competition. For example, RMR has curtailed the ability of firms to offer attractive tariffs for low volume users, and has also restricted competition between Price Comparison Websites (PCWs).

21. We have identified three areas of regulations that fail to give companies the right incentives to reduce their costs, with the result that customers are paying higher prices than they would otherwise. The first concerns the system for charging for **electricity transmission losses**.
 Transmission losses vary according to a generator's location, but the charges do not, which distorts competition between generators and increases overall system costs. The other two areas concern the **settlement systems for gas and electricity**. In relation to electricity settlement, suppliers are currently charged as if their domestic customers consumed according to a predetermined profile, such that they have no incentives to encourage their customers to shift consumption to times of the day when electricity is cheaper. In relation to gas, the current system leads to an inaccurate allocation of costs between suppliers and creates the scope for gaming behaviour.

The regulatory framework

22. The rules and regulations governing energy markets are set out in legislation, licence conditions and codes. These regulations have a profound effect on competition in both wholesale and retail markets, and we are therefore concerned that some key aspects of the structure and governance of the regulatory framework – including the roles and responsibilities of institutions and the design of decision-making processes – increase the risk of policies being developed in the future that are not in customers' interests and inhibit the development of policies that are in their interests.

23. Regulation of a number of aspects of the energy markets is governed by **industry codes**, which are managed by industry participants themselves. Whereas, **at the time of privatisation, there were two codes covering largely technical matters, there are now 11 codes, comprising over 10,000 pages of rules that cover a range of commercial and policy areas**. We are concerned that, where these rules affect competition and customers, Ofgem has insufficient ability to influence decision making, giving undue influence to established industry participants whose interests are not aligned with those of customers.

24. We have identified several examples of code changes that are in customers' interests but have been delayed or not implemented due to parties' conflicting interests and limited incentives to deliver the reforms, including Project Nexus, which is needed to address

the deficiencies in the gas settlement system but has been delayed several times since being initiated 7 years ago. We are also concerned to note that Ofgem has had no role in governing the distribution of prepayment tariff slots between suppliers under the codes, despite the fact that the lack of access to gas slots has been a major factor inhibiting new entry into the prepayment segments to the detriment of customers.

25. Regarding the **relationship between DECC and Ofgem**, we are concerned at the lack of a formal mechanism by which Ofgem, as the independent sector regulator, can express its views on policy proposals that have an impact on competition and customers and we have noted a lack of effective coordination between DECC and Ofgem when it comes to implementing key policies.

26. One of the reasons for the absence of trust in the sector has been the lack of a shared understanding of the drivers of price increases, and in light of this we consider that there is insufficient transparency over the impact of policies and regulations on energy prices and bills and that Ofgem lacks the requisite information to assess generation and retail profitability.

Customer detriment

27. The competition problems we have identified in this investigation are having a substantial detrimental impact on customers. To help us in the development of remedies, we have conducted analysis to quantify the size of this detriment.

28. By analysing the average prices offered by competitive new entrant suppliers, adjusting them to allow a normal rate of return, and controlling for exogenous cost differences, we estimate that **domestic customers as a whole paid an average of £1.4bn a year more than they would have done under well-functioning retail markets over the period 2012 to 2015, reaching £2bn in 2015**. We estimate that suppliers made excess profits of around £650 million a year from 2012 to 2014, which would imply that a large proportion of the detriment is driven by inefficiency.

> “Overall domestic customers have paid an average of £1.4bn a year more than they should have from 2012 to 2015

The detriment suffered by the prepayment customers of the Six Large Energy Firms equated to 12% of a typical bill, substantially more than customers paying by direct debit (8%) and standard credit (7%).

29. Regarding microbusinesses, we estimate, on the basis of our analysis of the excess profits earned by the Six Large Energy Firms, that over the period 2007 – 2014 microbusinesses paid about £180 million a year more than they would have done with a well-functioning competitive market.

30. Regarding other supply-side problems that we have identified, we estimate that the **failure to impose locational charges for transmission losses will add around £150 million to costs over the next ten years**. Regarding electricity settlement reform, there are potentially substantial savings from domestic load shifting in the future - **one study estimating savings from the introduction of time-of-use tariffs within domestic retail markets of between roughly £100 million and £350 million a year by 2025** – and we consider that settlement reform will be necessary to achieve the upper end of these benefits.

31. The detriment arising from the problems we have identified with the broader regulatory and policy framework is, by its nature, difficult to quantify, but it is likely to be very substantial. Regulations have a fundamental impact on energy markets and the costs of energy policies will comprise an increasing proportion of customers’ energy bills: DECC estimates that

climate and energy policies will add 37% to the retail price of electricity paid by households in 2020. The example of the non-competitive allocation of CfDs, which will likely increase customer costs by around £300 million a year, shows the importance of making robust decisions in this area.

Our package of remedies

32. The problems we have identified in the wholesale and retail energy markets are wide-ranging and our remedies package is therefore extensive and detailed: **there are over 30 remedies** in total, imposed through a combination of our order-making powers, undertakings from companies and recommendations to DECC and Ofgem. At a high level, the package has been designed to achieve four overarching aims:

    a. Creating a framework for effective competition

    b. Helping customers to engage

    c. Protecting those who are unable to exploit the benefits of competition

    d. Future-proofing our remedies by building a robust regulatory framework.

33. The different elements of the package are mutually reinforcing: energy markets in which suppliers operate free of inefficient restrictions can help drive down prices for customers, but only if customers are sufficiently engaged to make informed decisions about the choices available to them. And, by improving the governance of the regulatory framework, we can help avoid a recurrence of the regulatory problems we have identified in the past.

34. Given the level of detriment we have observed for prepayment customers, we have also decided to introduce a price cap for these customers during an interim period while our remedies take full effect. While this creates potential tensions with the aims of promoting competition and engagement, we have designed the cap in such a way as to allow competition to coexist with it.

35. An important development that is highly relevant to our consideration of remedies is the planned roll out of smart meters to all domestic customers by 2020. Smart meters have the potential both to address some of the technical constraints affecting competition for prepayment customers and to improve customer engagement more generally. We therefore think it is vitally important that the agreed timescales for the roll-out are adhered to and would expect Ofgem to use its enforcement powers effectively to ensure this happens.

Creating a framework for effective competition

36. In the long run, our remedies will address the supply side problems we have identified. In wholesale markets, they include: a recommendation to DECC to consult with a robust impact assessment before allocating a CfD outside the competitive process; and an order on National Grid to implement locational charging for transmission losses.

37. In retail markets: to help address constraints on competition for prepayment customers, we are introducing a cap on the number of gas tariff slots that any supplier can hold and giving Ofgem responsibility for allocating slots to suppliers; we are recommending that Ofgem replace the 'simpler choices' component of the RMR rules with a principles-based approach to ensuring tariffs are easily comparable; and we are recommending that robust plans be put in place for implementing a more rational, efficient system of gas and electricity settlement.

Helping customers engage

38. Certain categories of customer face specific barriers to engagement, which our remedies address: we are imposing an order on suppliers to make all their single rate tariffs available to customers on restricted meters; and we are recommending that Ofgem takes forward measures to address the difficulties faced by indebted prepayment customers in seeking to switch supplier.

39. However, for the majority of domestic customers, the challenge is primarily that they do not consider switching, or perceive the difficulties to be greater than they are. The key to unlocking engagement from such customers may be relatively simple – the way in which information is framed or the medium of communication, for example – but is likely to differ between types of customer and over time. Our approach to improving engagement reflects this in that – in contrast to previous interventions that have been tried in the past – it will be based on the use of evidence from trials and testing to identify what works in practice. In particular, we are recommending that Ofgem establishes an ongoing programme to test and implement information measures to help improve customer engagement, and have identified a range of interventions to test as a priority, including the provision of information on bills on the cheapest tariffs available in the market.

40. Our approach will also harness the incentives of suppliers and third-party intermediaries (TPIs) to engage customers. We are recommending the creation of a database of customers who have been on the SVT for three years or more to allow rival suppliers and Ofgem to prompt these customers to engage. Customers will be able to opt out of the database if they wish and Ofgem will be responsible for controlling access to it and testing aspects of its use – for example the frequency and form of communications – to ensure it is effective in helping customers move on to better deals. Our remedies also enhance the role of TPIs in increasing customer engagement by removing restrictions on their access to data and regulations that undermine their incentives and enhance the ability to promote engagement.

41. For microbusinesses, our remedies include an order on suppliers to disclose their prices publicly and prohibiting restrictive clauses that lock in customers.

Transitional price cap for prepayment customers

42. We believe that our remedies package will provide a long term solution to the problems we have identified on the supply - and the demand-side of the retail energy markets. However, our remedies will take time to have full effect and we expect that the detriment to domestic customers will persist form for the next few years. The detriment suffered by prepayment customers is particularly high and they have not been able to benefit from competitive prices in the same way as other customers due to the constraints we have identified. We have therefore decided to impose a price cap on the prices offered to prepayment customers during a transitional period (2017 – 2020).

> “Had it applied in Q2 2015, the cap would have reduced prepayment customers’ average bills by £75.

43. In deciding on the design and stringency of the cap, we have looked to reduce customer detriment while avoiding distortions to competition. **Had it applied in Q2 2015, the cap would have reduced prepayment customer detriment by about £300 million per year, equivalent to a reduction in average annual bills of around £75**. The level of the cap is in line with the cheapest prepayment tariff prices in many regions and will allow suppliers to offer competitive tariffs below the level of the cap. It will move every six months in line with a range of cost indices, allowing suppliers to manage their risks effectively. The cap will not apply to fully interoperable (SMETS2) smart meters, which will increase the incentives of suppliers to roll out such meters to the benefit

of prepayment customers. We anticipate that, as our remedies begin to take hold and smart meter roll-out increases, competition rather than the cap will be determining the prices paid by most customers, leading to a gradual glide path to the termination of the cap.

44. We have given close consideration to whether we should extend the price cap to all SVT customers in view of the high prices that they are paying. Our final decision was balanced. The majority of us concluded that attempting to control outcomes for the substantial majority of customers would run excessive risks of undermining the competitive process – notably by reducing the incentives of customers to engage and increasing regulatory risk - likely resulting in worse outcomes for customers in the long run. Martin Cave dissented from this view, considering that a broader cap was required to address the scale of detriment identified in the short term.

45. We have developed a package of reforms to the governance of the regulatory framework, which will improve the robustness of policy making in the future and help create a long term atmosphere of trust and regulatory stability. Our reforms include: legislation to clarify Ofgem's duties and objectives; a requirement on Ofgem to publish opinions on policy proposals and on DECC and Ofgem to publish joint plans for the implementation of policies; a recommendation to Ofgem to publish an annual report analysing the impact of policies and regulations; a requirement on the Six Large Energy Firms to provide financial information in a way that will help Ofgem carry out its functions; and a realignment of the roles and responsibilities of industry and Ofgem in relation to industry codes, giving Ofgem greater powers to influence decisions that have an impact on competition and customers.

46. These remedies represent a substantial reform package to 'reset' the regulatory framework governing the energy sector, clarifying and recalibrating the roles and responsibilities of Ofgem, DECC and industry to help ensure that regulatory and policy decisions in the future are robust and timely, and driven by a concern for the interests of current and future customers.

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> Our remedies package will revitalise the energy market

Conclusion

47. **Our remedies package will revitalise the energy market, intensifying competition between energy companies to bear down on costs, ensuring customers can make informed decisions about the range of options open to them and encouraging the development of smarter regulations that work in consumers' interests**. And for prepayment customers, who are currently unable to benefit from competitive prices, we have taken decisive action to reduce detriment directly through a price cap, while designing the cap in a way that will encourage more effective competition for such customers in the future. Allied to the changes that will be brought about through the full roll-out of smart meters and ever-easier access to data, we believe our remedies will bring about a substantial improvement in outcomes for energy customers over the years ahead.

Roger Witcomb, Chair,

Lesley Ainsworth, Member

Martin Cave, Member,

Malcolm Nicholson, Member

Bob Spedding, Member