



Department
of Energy &
Climate Change

The Rt Hon Edward Davey MP
Secretary of State

Department of Energy & Climate Change
3 Whitehall Place
London
SW1A 2AW

www.gov.uk/decc

Roger Witcomb
Competition and Markets Authority
By email

21 July 2014

Dear Roger

CMA REFERRAL

I would like to warmly welcome you as Chair of the CMA Group leading the market investigation of the supply and acquisition of energy in Great Britain. I would also like to welcome your wider team. This is an important moment for the energy markets so I am pleased that we have such an experienced and respected group of professionals leading the investigation.

The Government welcomes GEMA's decision to make a market investigation reference (MIR) in relation to the energy market. The Government commissioned the annual State of the Market report in October 2013 because competition is at the heart of delivering the best possible outcomes for the consumer.

The CMA and Ofgem identified some real areas of concern including: increasing prices and profits; higher market shares for incumbent suppliers; low switching rates; low customer trust; and persistent market segmentation. There is also evidence that profitability in the gas retail market is currently higher than that in the electricity markets with some companies appearing to tend to have higher prices. These are serious concerns that warrant the forensic examination that a MIR can bring so that we can move forward on the basis of sound evidence and work towards strengthened competition and a market that truly works for the consumer.

In their decision document Ofgem set out the market features that they consider make the case for a market reference. These are weak customer response, incumbency advantages, possible tacit coordination, vertical integration and barriers to entry and expansion. Ofgem's decision document also asks the CMA to consider market outcomes including profits and profitability.

We agree with Ofgem that these are the areas that the evidence from the State of the Market Assessment suggests should be the focus of the investigation. We also agree that

there are some areas such as networks, interconnection and the wholesale gas market which should not be included:

- *Networks:* The gas and electricity networks are natural monopolies regulated by Ofgem and whilst it is important that the links to competition in the wholesale and retail markets are not ignored, a fundamental review of regulated monopolies, like the DNOs, is not necessarily consistent with a competition investigation;
- *Interconnectors:* The European Commission is bringing forwards a number of Codes which will significantly change the regulatory framework for both gas and electricity interconnectors, and it would be both challenging and of limited value to fundamentally review a market which is going through this level of change;
- *Wholesale gas market:* While wholesale gas markets have important links with electricity markets, where vertical integration is an issue which is rightly down for consideration, wholesale gas market concentration is lower and liquidity significantly higher.

It is of course for the CMA to decide on the exact focus of the market investigation.

Delivering Government objectives in a changing context

The Government wants to see:

- A market that is fit for purpose and delivers our priorities for secure, low carbon energy supplies at the least cost to the consumer. We consider that protecting the consumer interest includes ensuring secure and reliable energy supplies;
- A market that delivers the investment we need to meet our objectives and support economic growth and has the confidence of market participants; and
- A market that is trusted by consumers who are willing and able to engage with the market.

Since privatisation and the end of the power trading pool and the move to the current bi-lateral electricity trading arrangements (now called BETTA) our energy markets have changed significantly. Retail competition has been introduced, price regulation of supply has ended and the structure of the market is very different today – for example we have seen the growth of the vertically integrated energy companies, diversification of our gas supplies and development of low carbon generation.

It is not just the market framework itself that has changed significantly. This Government faces a series of challenges in continuing to deliver secure, low carbon, affordable energy:

- Rapid closure of existing capacity as older, more polluting plant go offline;
- Diverse sources of electricity generation with greater intermittency from renewable generation requiring a more flexible system of generation to ensure that there is sufficient capacity in times of peak demand; and
- Changing demand patterns, either through businesses/consumers being incentivised to smooth demand patterns or new technologies creating different demand curves (e.g. electric vehicles)

Meeting these challenges and delivering an energy system that can meet these and future challenges requires significant investment and the emergence of new, innovative businesses and services.

Up to £100 billion of capital investment is needed in the electricity sector from now until 2020 and up to £7.6 billion in gas networks. Since 2010 we have achieved more than £45 billion of investment in electricity generation, £14 billion of this came in 2013. The Government's Electricity Market Reform (EMR) programme was introduced in order to maintain security of supply in a context of the large volume of electricity plants that are expected to close, make progress towards decarbonisation targets and ensure that consumers pay a fair price for electricity..

EMR sets the framework for investment in the electricity sector and is now delivering with the first investment contracts for low carbon generation allocated. Competition is at the heart of these reforms; support for low carbon generation (through Contracts for Difference) will be delivered by competitive allocation as far as possible and the proposed Capacity Mechanism is a market based instrument. EMR is intended to enable a wide range of investors to participate and that the wider market is fair, open and competitive with low barriers to entry. EMR will provide important context to the CMA investigation in relation to the shape of the future market, but we do not think the design of the programme should be an area of focus. It is for Government to deliver EMR, an important step in strengthening investor confidence and providing the framework for investment. We would expect the CMA to consider how the wider market can deliver better outcomes for consumers given the framework Government has established.

Investment will also need to be complemented by innovation if we are to meet the challenges faced in the energy sector. It is therefore important that the market is open to new and innovative business models that are able to provide consumers and businesses with the demand side response and demand reduction services that the rollout of Smart Meters will unlock and the introduction of additional intermittent generation will demand. We would expect the CMA to take into account both the broad direction of travel of the energy markets as well as key developments that will affect the way it operates in the future.

The importance of competition

The Government strongly supports effective competition as the most efficient way to deliver energy at the lowest cost to consumers, and this has been the focus of Government (and Ofgem) activity in the retail and wholesale energy markets.

We provided statutory backing to Ofgem's Retail Market Reforms. These ambitious reforms have now been implemented and are making the retail market simpler, clearer and fairer for consumers, enabling them to engage better with the market and to ensure that they are getting the best deal that meets their preferences.

We have also promoted competition in the retail market through reducing barriers to entry and growth for new market entrants. The increase in thresholds for participation in government social and environmental schemes has reduced disproportionate costs on smaller suppliers and has allowed them to grow, as well as encouraging new entrants into the market. As a result, there are now 19 independent suppliers operating in the domestic retail market, who have between them increased their market share in the last year to nearly 6% of the market. The Department is continuing to work with small suppliers to ensure that they are able to operate effectively in this complex market and grow in a sustainable way.

The obligation on energy suppliers to complete the rollout of smart meters to domestic and smaller non-domestic premises in Great Britain by 2020 is central to the Government's objectives to improve competition in the retail energy market. Smart metering will reduce the costs to serve for energy suppliers in the medium term (in particular pre-payment metering); provide accurate consumption data that empowers consumers to make informed decisions; and enable faster, more reliable switching.

In terms of wholesale markets the EMR programme continues the focus on strengthening competition by being designed to enable new entrants. The introduction of CfDs should make it easier for independent generators to find a route-to-market and additional supports are also being introduced to ensure that independent generators are able to sell their electricity throughout the duration of their project. The Government has also given statutory backing to Ofgem's 'Secure and Promote' liquidity reforms, which provide essential market access for independent suppliers and generators.

During the course of the market investigation the Government (with Ofgem) will continue work to get a better deal for consumers. Our work on promoting faster switching will lead to switching times being halved by the end of the year and we will continue to make progress towards our aim of 24 hour switching. We will drive forward the implementation of the next phase of midata and ensure that the automatic transfer of customer data (with permission) between suppliers and third parties becomes a reality in order to further facilitate simple, quick switching. The Government will continue to work to provide consumers with the means and information to enable them to manage their consumption in a way that reduces their energy use and costs. This includes efforts to increase energy efficiency through the Green Deal and ECO and the mass roll out and use of smart meters

(from late 2015) which will leave consumers better placed to adopt such measures. Smart meters and associated technologies offer new opportunities that will have a significant impact on how the future energy market operates.

The Market Investigation Reference

Despite the actions the Government and Ofgem have taken and are taking, the State of the Market Assessment clearly showed that there are a number of persistent problems with the market and that important indicators such as customer switching and engagement have deteriorated. It will be important to make sure that the relationship between wholesale and retail prices is thoroughly examined. We supported Ofgem's action to request that the major suppliers explain why recent falls in wholesale costs have not affected retail prices and consider that the market reference is the correct vehicle to examine this in more detail.

Overall we consider that an independent, apolitical and forensic investigation is the best way to ensure lasting outcomes that have the confidence of consumers, investors and the market.

The Government wants a market investigation that is completed within the new statutory time limit in order to minimise investor uncertainty and deliver results for consumers as soon as possible. Ultimately the outcomes should give consumers confidence in the operation of the markets and strengthen their ability to engage with the market.

During the course of the investigation we hope that the CMA will particularly take into consideration:

- The importance of security of supply as a fundamental element of a competitive market. A pre-requisite for a successful energy market is that it must meet consumers' reasonable demands;
- How we can ensure all consumers – including vulnerable consumers – see the benefits of competition; and
- How we can ensure that the development of innovative and alternative business models are not stifled including how we ensure consumers benefit from smart technologies.

DECC is ready to support the CMA process and provide evidence information and advice as requested. In the event that the CMA considers that Government should act we are committed to engaging constructively and responding as quickly as possible.

Edward Davey

EDWARD DAVEY