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Date: 14th August **To:** Project Manager Energy Investigation Team, CMA
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Consultation Response

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Energy Market Investigation - Statement of Issue

Which? is the largest consumer organisation in Europe. It is an independent, not-for-profit consumer organisation with almost 800,000 members. Which? is independent of Government and industry, and is funded through the sale of Which? consumer magazines, services and books. Which?'s mission is to make individuals as powerful as the organisations they have to deal with in their daily lives.

Energy is a top financial concern for consumers.[1] Most consumers don't trust the industry[2] nor do the majority of consumers have confidence that they are being charged a fair price.[3] Contributing to this, as Which? has long argued, are market arrangements that are failing consumers.

The introduction of competition in gas and electricity was intended to protect the interests of consumers by putting them in the driving seat.[4] With consumers allowed to choose their energy supplier, former state-run monopolies would face strong incentives to transform themselves into dynamic, modern companies. Customers would not only be offered a choice of appealing, innovative, good-value products, but also great customer service. Which? believes that consumers should be the engine of competition, with individual choices of the best products ensuring efficient and competitive prices by driving down both wholesale and retail costs. And as a result, consumers – who have no choice but to buy energy – would feel empowered and in control.

[1] 76% of consumers worry about the cost of energy, Which? Consumer Insight tracker http://consumerinsight.which.co.uk/
[2] 20% of consumers trust gas and electricity suppliers, Which? Consumer Insight tracker http://consumerinsight.which.co.uk/
[3] Six in ten do no trust suppliers to charge a fair price for their energy,1913 UK Adults, February 2014, Which? Energy Tracker
[4] Utilities Act 2000, chapter 27, part 2.

However this has not happened. Which? supported Ofgem's proposal to refer.[5] Through the Energy Market Investigation the CMA must conduct a comprehensive assessment of all the factors impeding competition and resulting in poor outcomes for consumers, and develop a set of reforms to transform the energy market arrangements so that they deliver for consumers as well as industry.

Set out below is a summary of evidence relating to the four theories of harm, followed by our views on why the practices for developing and producing price data in gas wholesale market should be fully included in the scope of the investigation.

Theories of Harm

Theories of Harm 1-3

In July 2013 we published the *The Imbalance of Power - Wholesale Costs and Retail Prices*[6] which explored a number of issues that appear to inhibit the ability of the relationship between the wholesale and retail markets to deliver efficient prices that consumers can have confidence in. This included liquidity in the power markets and the lack of robust price indexes in both the wholesale gas and power markets - two issues that affect the related outcomes of efficient prices and quality price information.

As our report sets out the processes used to gather and publish price data by price reporters is not robust, often relying on human reporting, rather than transactional data. This is a similar approach to that which was used in Libor reporting, the outcome of which is well reported. This methodology is common to both the power and gas wholesale markets. So while there is greater liquidity in the wholesale gas market, questions remain regarding the integrity of the price data derived from this market. This has important implications for suppliers buying across both fuels, cross fuel-hedging, transfer pricing (for gas and power) and in the future for reference prices for Contracts for Difference.

This report also presented evidence that within the large vertically integrated companies, the incentive to deliver for their shareholders appears to come at the expense of delivering low prices for their customers. These six companies may benefit from the efficiency of vertical integration themselves – through lower risks and shared costs. But there is no evidence that the benefit of this efficiency is shared with their existing or prospective customers in the form of lower prices. Indeed, it is the small, independent energy suppliers – who do not share the economies of scale or vertical integration – who have often offered more competitive prices. Furthermore, transfer pricing (the process by which the companies sell energy from one part of the business to another) is opaque at best. The Ofgem-commissioned investigation by accountancy firm BDO into transfer pricing within the large vertically-integrated companies found a mixed picture. And Ofgem has questioned whether there could be confidence in transfer pricing charges to suppliers as many of the prices the supply businesses paid were benchmarked to markets that weren't competitive.

Vertically-integrated companies can also move and split margins within and between their business segments, so that they can balance low margins in one segment with higher ones

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[5] Which? response to Consultation on a proposal to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain, Ofgem, March 2014

[6] The Imbalance of Power - Wholesale Costs and Retail Prices, Which?, July 2013, http://www.staticwhich.co.uk/documents/pdf/the-imbalance-of-power-wholesale-costs-and-retail-prices-2-330836.pdf

elsewhere and so deliver an overall positive financial performance at group level. They can do this at a national level or even, where relevant, at an international level. This process has been described as 'chasing margins up and down the value chain'. These practices raise questions about whether the companies are pushing profits into the generation parts of their business to make the retail market look less attractive to prospective entrants and to 'justify' the level of energy prices. The result of companies managing margins in this way would be that prospective investors or new entrants to the market would not get a true picture of the likely returns and so could be deterred. Yet their involvement in the market is crucial for its long-term sustainability.

Compounded by the lack of demand side pressure, with limited numbers of consumers moving away, it makes sense for these companies to keep prices high. The evidence suggests that these vertically-integrated companies may make less profit overall if they reduce retail prices, even if they acquire more customers and sell more energy as a result. If they increase retail prices, it may result in losing a small number of customers and selling less energy but overall profits increase. And the most effective way to do so – to the benefit of overall company performance – is to increase the wholesale costs. Through this approach all consumers will pay this inflated price regardless of who their supplier is.

Vertically-integrated companies are able to supply themselves with electricity and this type of self-supply is said to account for a significant share of wholesale electricity sales in the UK. Self-supplying reduces the amount of price information available for others to use as benchmarks or reference prices because the prices that the upstream electricity generation or gas production businesses charge their own supply businesses are not published. It also reduces both the volume of energy available for sale to other suppliers and the amount of energy that suppliers need to buy on the open market from other generators. The combined impact of these factors has raised concerns that the dominant position of the six major energy companies is having a detrimental impact on independent suppliers and generators – by limiting the availability of volumes, buyers and purchase agreements and so restricting the total amount of competitive activity in the market.

These are significant issues that impact on the effectiveness of competition in these markets and ultimately on the price that consumers pay for these essential services.

<u>Theory of Harm 4</u>
The energy retail market is not working for consumers. As our report *The Imbalance of Power - The Retail Market*[7] set out, effective competition in the retail market is hampered by a number of factors including complex pricing and entrenched disengagement. This has come about as a result of the regulatory framework and supplier behaviour. This results in the paradox of high levels of consumer worry over energy costs but with the majority of consumers disengaged and many languishing on expensive tariffs to the tune of an estimated £3.9bn.[8] As consumers are unable to easily identify the best deals, they are also unable to play their role in driving competition.

Furthermore, competitive pressure on suppliers to seek out the best possible prices for their customers or improve their services or the quality of their communications is limited. This in

[7] The Imbalance of Power - The Retail Market, Which?, December 2012, http://www.staticwhich.co.uk/documents/pdf/the-imbalance-of-power---which-report-308858.pdf
[8] Which? estimate of how much consumers were overpaying by not being on the best tariffs, September 2013.

turn contributes to the perception that all suppliers are the same and to chronic disengagement in the market. Poor customer service is well illustrated by the persistent low levels of satisfaction for the largest suppliers. In the last Which? annual satisfaction survey the average level of satisfaction was 41% with the largest providers falling within the 45-31% range.[9] These low levels of satisfaction are some of the lowest levels of satisfaction across a number of industries recorded by Which?. Another example is the way in which some suppliers appear to prioritise answering sales calls over customer service calls.[10]

The suppliers are also able to segment customers, enabling cross-subsidisation between groups and better treatment of certain groups of consumers. For example, suppliers do not have to make all tariffs available on all payment methods - an activity that Which? has long argued is unfair. The result is that some of the best deals are only available to those consumers who are willing and able to pay by direct debit and manage their account online. Consumers on traditional time of use tariffs, such as Economy 7, appear to be another such group of consumers who fare particularly badly. For example, a recent Which? investigation found that despite Economy 7 tariffs being designed to make electric heating more economical, some of these customers would in fact be better off on standard tariffs rather than certain Economy 7 tariffs.[11] We have also found evidence that price increases for some Economy 7 tariffs are greater than for standard electricity.[12] Regarding understanding of the tariffs and information requirements, consumers are often unaware of what the off peak hours are and/or are unable to find the information on suppliers' websites.[13] There have been well documented cases of meter clocks going wrong and customers unknowingly under or overpaying.[14]

Ofgem's Energy Supply Probe and Retail Market Review (RMR) were major actions by the regulator and resulted in some improvements to the retail market, mainly in the area of customer communications. While the changes to tariff structures implemented through the RMR were an improvement from tiered tariffs, our own research has shown that further simplification through the introduction of simple unit rate pricing would improve consumers ability to identify the cheapest tariff at a glance, without having to consider their consumption.[15] Simple unit rate pricing would help focus attention on price. We believe it would be an important element of an effective market, alongside greater visibility of pricing, compelling offers and quicker switching - all of which should help encourage more engagement.

It is essential for consumers to have a choice of suppliers in a competitive energy market. However, the benefits of those suppliers offering a large number of complex tariffs are less clear cut. Choice only has value if consumers can meaningfully differentiate between the offers available and move to the one that's best for them. If they cannot, companies may be able to segment the market and focus their most competitive offers on a small group of more active consumers, while extracting higher returns from those who are not engaging with the market. This is a particular risk in markets like energy that supply a service that consumers have no choice but to buy. Simple unit rate pricing, together with a number of rules such as

[9] Energy Satisfaction Survey, Which? Magazine, February 2014
[10] Which? Magazine, June 2014 p5 and Which? Magazine December 2013, p7
[11] Which? Magazine, September 2014, p8
[12] Which? Magazine, June 2014 p8
[13] Which? Magazine, March 2014, p7
[14] Which? Magazine, May 2014 p5
[15] Which? Magazine, April 2014

having all tariffs available on payment methods,[16] would be an effective way of addressing tariff proliferation without capping the number of tariffs. Through this approach, the price of deals would be clear and through effective competition, all but the best deals would be eroded away.

We welcome the CMA's statement that a well-functioning market is one that works well for consumers.[17] We believe that effective competition can only be driven by consumers making the best choices for their circumstances - which they are currently not in a position to do, in large part because of poor price visibility. The retail market arrangements must enable consumers to actively engage and drive competition. We also recognise that there will be some consumers who are unwilling or unable to engage with the market, and reflecting that energy is an essential - the market arrangements must work for all consumers. All consumers should have efficient, fair prices and have confidence in the price they pay. It is crucial that in both the assessment of detriment and the development of remedies, the CMA must give full consideration to the outcomes for all consumers and what will enable them to drive competition.

And as we have summarised above, the market arrangements so far have not delivered this. Together with considering what more must be done to deliver clear, visible pricing, including single unit and national pricing, within the existing framework, we believe that serious consideration should be given to hybrid models, such as that found in the State of Illinois.[18]

As we described in our retail market report, consumers in the US State of Illinois have a choice of either one electricity supplier whose prices are regulated (known as 'the utility') and other suppliers whose prices are not regulated. As in Britain, consumers can choose between fixed- and variable-price tariffs, as well as some green options. The utility is tasked with securing electricity in a competitive and cost-effective manner. As it makes a regulated return from its ownership and operation of the physical distribution network, there is no mark-up or profit on the price it charges. This creates a competitive benchmark price or 'price to beat' for alternative suppliers to aim for, while ensuring that customers who do not switch still receive a fair price.[19]

Comparing prices is straightforward, consumers only have to compare the unit rates of the different suppliers to check whether they could save money by switching.

In March 2011, the Illinois regulator re-launched its consumer website to provide consumers with a price comparison table showing the unit price they would have to better, in order to save money by switching, as well as advice on how to choose an electricity tariff. Between the time of the re-launch and December 2012, the number of consumers switching away from the utility has increased from around 2,000 to more than 1.5 million, with much of this uplift driven by municipal collective switching initiatives.[20]

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[16] Recommendation 2, Chapter 5, Imbalance of Power - The Retail Market, Which? December 2012
[17] Paragraph 17, Energy Market Investigation - Statement of Issues, Competition and Markets Authority, July 2014
[18] Chapter 5, The Imbalance of Power - The Retail Market, Which?, December 2012, http://www.staticwhich.co.uk/documents/pdf/the-imbalance-of-power---which-report-308858.pdf
[19] The fair price is determined by an electricity procurement strategy set by the regulator. This means that it is not the price of the electricity itself that is regulated, but the process of buying it.
[20] 2,034 customers in March 2011 had electricity from an alternate retail energy supplier - International Approaches to Energy Retail and What the Future Could Hold, a Baringa report for Which?, April 2012, pg 57. This has now reached 1.5million www.pluginillinois.org

Which?

Price data in the wholesale Gas Market
Which? believes that the process for establishing and producing price data in the gas market should be included within the Energy Market Investigation.

Along with the trading that occurs within the wholesale gas market, the surfacing of robust price data is integral to how well the wholesale gas market is functioning. While there is greater liquidity in the wholesale gas market in comparison to the power market, the processes for surfacing and producing price data are the same. We consider these processes to be vulnerable to manipulation. As we set out in our report the I*mbalance of Power - Wholesale Costs and Retail Prices*, and as Ofgem set out in the call for evidence on price reporters,[21] price reporters get their data by surveying market participants rather than directly from data. Traders are a key source of information and may provide information from a range of sources. For example, it may include trades that they have undertaken, trades they know of, as well as the range of bids and offers available in the market.

There are strong parallels with the Libor scandal. As the Wheatley review of Libor said, 'submissions were reliant on judgement, rather than transaction data'. As in the Libor assessment of bank lending rates, the administrative mechanism in energy price reporting provides opportunity for contributors to attempt to manipulate submissions, as submissions are not always based on transactions and the process is self-policing.

Given the important role this that price data plays, such as for example in setting contract terms, to inform bids and offers for volumes of energy, hedging and to set or inform transfer prices, as well as to inform prospective investors - reform is needed to deliver robust data that is not vulnerable to manipulation.

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[21] Paragraphs 2.15 and 2.17, Ofgem, Price benchmarks in gas and electricity markets – a call for evidence, June 2013