ENERGY MARKET INVESTIGATION

Summary of hearing with Ofgem on 10 November 2014

Background

1. The Office of Gas and Electricity Markets (Ofgem) saw its primary duty as protecting the interests of consumers and believed competition was the most effective means of achieving this. The decision to refer the energy market for investigation had been taken because of concerns that competition was not delivering the desired outcomes.

2. Ofgem believed there were many problems in the energy market that had persisted for a number of years and which had gradually worsened. The joint assessment between Ofgem, the Competition and Markets Authority (CMA) and the Office of Fair Trading (OFT) had crystallised what these were and the CMA’s initial statement of issues broadly addressed the problems that Ofgem believed existed in the market.

3. The public profile and technical complexity of the energy market differentiated it from other competitive markets. Energy provision was an essential service, and the impact of energy prices on consumers and the competitiveness of the economy was often discussed in political and public debate. The technical requirements of delivering energy were complex, particularly the requirement to balance energy supply with demand on a daily basis in the case of gas and on a minute-by-minute basis in the case of electricity.

4. Ofgem performed a complex set of duties of which the promotion of competition was only one, and it was necessary to consider how these duties interacted when reviewing Ofgem’s decisions and the reasoning behind them.

5. Ofgem’s introduction of the undue discrimination licence condition, SLC25A, was an example of a decision influenced by its duty to protect the interests of vulnerable consumers rather than competition considerations. At the time the regulation was passed, the government was preparing to use its powers to implement similar regulations itself. Ofgem had explicitly said that the impact of SLC25A would be difficult to predict. The potential damage it could cause to competition was recognised and that was why steps had been taken to limit the negative impacts on competition, including a sunset clause in the regulation which meant that the default position was that it would expire in 2012, which it had.
6. The energy market was constantly changing and developing. The impact of smart-grids and smart metering, the government’s electricity market reforms and the increasing importance of European integration and the impact this would have on the codes that underpin the energy market’s structures could all have important implications for businesses and consumers. It would be important to take these changes into account in the CMA’s assessment of the market and the consideration of any remedies deemed appropriate.

7. Ofgem stressed the need for independent economic regulation of the energy sector which should be viewed as a cornerstone of how the sector works.

**Ofgem’s objectives for the energy market and competition**

8. Ofgem did not believe the promotion of competition was inimical to its responsibilities to vulnerable customers. Competition protected the interests of consumers, and Ofgem encouraged it wherever possible so long as doing so was consistent with its other duties. Its regulatory activities also played a direct role in protecting consumers, especially vulnerable ones. Over the past ten years, legislative changes had led to Ofgem’s competition duty to be down-rated relative to its other duties. As a result, Ofgem’s objectives were not entirely simple or clear. Ofgem noted the potential of the Stategy and Policy Statement to improve this clarity.

9. Energy supply and generation were inherently competitive activities and should remain so, with competition strengthened as far as was practicable. Traditional monopoly networks, again, where practicable, were also areas where increasing the role of competition could be pursued.

10. Ofgem considered that it had a good relationship with the Department of Energy and Climate Change (DECC). Each had a role that was clearly defined, though in some cases Government’s policy objectives could lead to overlaps between its work and Ofgem’s. In these cases there could be some uncertainty as to the boundaries of their respective roles and this had caused some confusion in the industry.

11. Ofgem believed that recent developments in the energy market had provided further evidence for what it termed the ‘rocket and feather effect’, whereby the larger suppliers do not fully pass on falling wholesale prices to consumers through lower retail prices.

**Generation and wholesale markets**

12. Ofgem believed the primary problem in the energy market was in the retail sector, particularly customer engagement. In the wholesale market, its key
concern focused on liquidity and the ability of independent energy companies to have access to the products and robust prices necessary to be active market participants.

13. Ofgem, through its monitoring of competition in the gas and electricity markets, had not unearthed evidence of unilateral market power in the wholesale market. It had looked at a number of indicators such as market shares, concentration and ‘pivotality’ analysis and had concluded that the ability did not exist to massively manipulate the energy wholesale market. However, Ofgem would continue to monitor the market for signs of manipulation. The Regulation on Energy Market Integrity and Transparency (REMIT) also provided Ofgem with information gathering powers which enabled it to monitor trades and take action if it suspected market manipulation or insider trading.

14. In due course, REMIT was going to provide Ofgem with greater monitoring powers, such as access to more information about individual trades and trades within companies, which it currently did not have.

15. Ofgem’s energy probe in 2008 gave rise to the development of its objectives in relation to liquidity in the wholesale market. During the course of Ofgem’s liquidity project, improvements were seen in near-term liquidity and Ofgem was focused on ensuring that these increased levels of liquidity were then retained. Ofgem also sought to ensure that independent companies could access products along the forward curve and that prices were robust.

16. The latest part of this project was Ofgem’s ‘Secure and Promote’ licence condition, which was designed to improve liquidity in the wholesale market, and came into effect in March 2014. Indicators had been positive in 2014, with an increase in churn and a reduction of bid offer spreads in the market. However, the intervention had been in place for less than a year so it was too early to draw definitive conclusions on its impact or to identify a causal link between the intervention and improvements in liquidity. The mandatory market-maker element of the reforms, a licence condition placed on certain generators, ensured that energy companies had access to a broad range of forward energy products.

17. The real test of the liquidity reforms was to move the market from its current, low levels of liquidity to a more positive state where new players are attracted to the market who are able to help independent players get access to the wholesale market products they need to compete effectively. It was hoped that new, financially strong, entrants would emerge and offer benefits such as better credit arrangements for independent players, therefore removing an
aspect of the market that independent operators often cited as a significant barrier to entry.

18. One concern raised about the reforms was that mandatory market-making would suck liquidity out of other periods of trading. There was so far no evidence of this occurring, but the effect of the reforms was kept under constant review. Ofgem also undertook an impact assessment of the reforms, which involved ongoing data collection and meetings with the parties the measures were intended to benefit.

19. Ofgem had worked to ensure that the Secure and Promote licence condition would remain stable as obligated parties had expressed concerns that the finalised proposals would be subject to continuous change. While there were no current modifications planned to Secure and Promote, feedback Ofgem received from independent suppliers and generators on the reforms’ impact was informing its ongoing policy developments.

20. Ofgem was aware that some large, financial organisations had entered the Great Britain (GB) gas and electricity market as traders as they saw a potentially positive upward trend in liquidity.

21. In its previous work on the retail market Ofgem had found evidence that was consistent with the existence of coordinated effects. However, Ofgem had not seen similar evidence of coordinated effects in the generation market in recent years. Furthermore, it had not identified the existence of unilateral market power in the generation market taken as a whole.

22. Ofgem believed that some concerns about the wholesale market related to its structure, rather than the existence of market power in an individual or coordinated fashion. The question was whether the current structure of the wholesale market was appropriate to facilitate competition and produce noticeably beneficial competitive effects for consumers.

23. Ofgem did not have any conclusive evidence that the structure of the wholesale market was a problem, but it hoped that the CMA investigation would look into this issue, including how wholesale markets operated elsewhere in the world, and provide some clarity about whether the current structure of the wholesale market was consistent with effective competition.

**Capacity**

24. Ofgem believed that the extent to which an energy-only market would deliver security of supply, because of the impact it had on the economics of fossil fuel generators, would inevitably be called into question once contracts for
difference (CfDs) were in place for renewable generators. A clear link existed between the decision to provide support to one set of generators and the need for other measures to sit alongside the energy market to deliver capacity adequacy requirements.

25. During 2009, Ofgem had identified aspects of the cash-out arrangements in the electricity market which mean that these arrangements did not provide enough incentives and price signals for investors, particularly in flexible generation. Ofgem had sought to address this problem via reforms to the cash-out mechanism implemented through changes to the balancing and settlement code, while in parallel the government had looked to do so by introducing the capacity market.

26. Ofgem had worked closely with industry in developing the cash-out reforms, and it hoped this cooperation would overcome any speculation regarding the reforms’ ability to deliver the desired flexibility. Ofgem was keen to ensure that the industry had sight of the cash-out reforms ahead of the capacity auctions in 2014, ensuring that bidders would have sufficient clarity of the possible revenues in a post-cash-out reform world so that the two interventions would be compatible and the costs for consumers would be minimised.

27. The proposed changes were complicated, but Ofgem had worked closely with DECC with regard to the timing of implementation of the cash-out reforms and the proposed changes to the capacity market. The two reforms addressed different issues: while the capacity mechanism would ensure a given level of capacity adequacy, the cash-out reforms would ensure efficiency in balancing the system. However, the two reforms were consistent: for example, particular care had been taken in designing the penalty arrangements in the capacity market and the extent to which cash-out was allowed to move to the value of the lost load.

Transmission constraints

28. Initial evidence showed that the Transmission Constraint Licence Condition (TCLC) had led to a change in bidding behaviour of the parties affected by the licence obligation. In order to monitor compliance with the licence condition Ofgem had contacted parties when it identified unusual bidding behaviour. This had sent a clear message to the market that Ofgem was focused on ensuring that firms were not able to exert market power resulting from transmission constraints.

29. The TCLC was time-limited and Ofgem would assess the impact of REMIT before it decided whether the condition had become redundant.
30. Ofgem said that locational pricing was not currently an issue it was considering, but under new European network codes, it was required to monitor how the market was working and to consider whether the appropriate bidding zones existed. From a European perspective, national boundaries were not necessarily the logical delineation of bidding zones and once the European network code was in place, Ofgem might be required to periodically issue information on its assessment of whether the appropriate configuration existed in the GB market.

31. Alongside Ofgem’s day-to-day monitoring of the energy markets, its ‘Future Trading Arrangements’ programme was intended as a horizon-scanning exercise to assess whether the detailed rules and trading arrangements needed to be altered to further benefit GB consumers or to deal with risks that changes may bring. Ofgem would not develop any significant work for this programme during the CMA’s investigation, but it would hold a forum with industry to keep it informed on regulatory developments and to identify priorities as the CMA’s investigation progressed.

**Wholesale gas market**

32. Ofgem actively monitored the gas wholesale market and as with the electricity market, its monitoring had not discovered evidence of market power. The GB gas market had the lowest concentration of any European market and the concentration level was even lower than that of the USA. When compared to the electricity market, the gas market was characterised by high levels of liquidity and low levels of vertical integration.

33. Ofgem had conducted pivotality analysis that showed limited instances of pivotality in the market. Supplies would have to be withheld for several months to exert that pivotality impact on the market, and there was no incentive for it to do this.

34. Ofgem had significant, statutory powers under REMIT and the Competition Act to investigate, and request information from, parties if there was genuine concern about their behaviour. As with the electricity market, if suspicious trades did come to light; then where appropriate a formal investigation was to be opened.

**Retail market**

35. Though there had been positive growth for some of the smaller suppliers over the last five or six months, Ofgem did not believe that this increased market share should be viewed as an indicator that the retail market was now functioning more effectively. The last six months had had uniquely favourable
circumstances for small suppliers, with high levels of customer dissatisfaction with the incumbent suppliers and the wholesale market operating at a substantial discount to what the largest six suppliers had hedged next winter.

36. Over the same period, the six largest suppliers had reduced their retail prices, but not to the extent that might be predicted by the trend in wholesale prices. These slight price reductions did not accord to what was expected in a competitive market and this behaviour had provided further evidence for the rocket and feather effect, which was reasonably well established over the preceding five or so years. The real test of change would be the level of market penetration when conditions were more difficult for new entrants or smaller suppliers.

Retail Market Review (RMR)

37. The impact of the RMR would be subject to a sophisticated and detailed evaluation by Ofgem. As yet it was too early to give any overview of the RMR’s effect, but there were early indications that switching decisions were being made as the result of better information. A recent survey had found that 70% of consumers who had switched believed they had moved to a better deal, which was in contrast to the feedback Ofgem received that the previous array of available tariffs was confusing and undermined confidence in switching.

38. Evaluating the impact of the RMR would be difficult because the reforms were intended to change consumer behaviour, which would take time. The review of the RMR was also intended to identify any unintended consequences that had concerned Ofgem when the reforms were enacted.

39. Attention had focused on the information remedies and the restrictions on tariffs contained in the RMR, but just as important were the new Standards of Conduct which were intended to ensure that suppliers treated their customers fairly. This new principle-based approach would need to be in place for some time before its effectiveness could be assessed. One approach taken to get an indication of the reform’s impact was to hold informal sessions between suppliers and a panel of consumer experts. At these sessions, suppliers would relate the impact that the standards of conduct were having on their business and business decisions, and Ofgem would publish a summary of the lessons and issues that had arisen.

40. When developing the proposal for the restriction of tariffs, a difficult balance had to be struck between making the market simpler for the consumer without removing tariffs that people liked or restricting innovation. Internal debates had taken place regarding certain tariffs, particularly dual-fuel and on-line
discounts, and concerns were also expressed regarding the removal of prompt-pay discounts. Research had shown that contingent discounts can impact on people’s decisions and prompt-pay discounts may attract consumers for whom they do not provide good value. The decision to remove these tariffs was the result of a decision to err in favour of simplification over a set of tariffs whose removal continued to be controversial.

41. The decision to move to four tariffs reflected strong customer evidence, based on the view at that time, that people were confused by the large number of available tariffs. Limiting the number of tariffs was an attempt to help consumers rebuild a greatly diminished degree of trust and confidence. The limit on tariffs was not intended to be a long-term solution, but was part of an attempt to increase consumer trust and confidence in the market. Over a period of time, the number of tariffs could be increased, with a fuller set of innovations materialising.

42. A lot of the information required to appear on bills was the result of government and European requirements. There was room for simplification and work was ongoing with consumer bodies, government departments and suppliers to address this issue.

43. Ofgem believed the potential existed for better engagement with suppliers as it believed it and the suppliers both shared the same objectives of simplifying the detailed requirements faced by suppliers, for example in relation to their telephone conversations with suppliers.

44. To a large degree, RMR reflected the desire to move towards principle-based regulation, where the duty to treat customers fairly was intrinsic among suppliers. There was a danger that many suppliers, particularly the large incumbents, engaged in a box-ticking exercise, particularly for someone who wished to switch, and stated that this is entirely consistent with their regulatory obligations. Ofgem recognised that there were some exacting regulations, but it believed it was also in the interest of certain parties to interpret them in this fashion.

45. Ofgem had heard arguments that the length and intensity of the licence requirements were a potential barrier to entry for new suppliers. Ofgem had sought to move away from such a prescriptive regime, to a more general, principle-based approach over time, but such a move had to take into account a market where it believed consumers had been treated very badly by suppliers over the past few years. There was a desire to signal that Ofgem wanted to move towards a less intrusive regulatory presence, while ensuring suppliers offered a certain level of quality.
46. Ofgem had found it concerning that while it had offered certain suppliers the possibility of derogations from the four-tariff rule to ensure vulnerable customers were not disadvantaged in any way, for example, allowing the use of tariffs that would alleviate fuel poverty, this had not been taken up. It had voiced its concerns publicly and the reluctance of suppliers to take advantage of this derogation endorsed Ofgem's concern that specific matters were being approached in a 'tick-box' manner, with little flexibility demonstrated by the industry.

47. Ofgem was aware that price comparison websites (PCWs) were used as a vehicle for switching suppliers and was concerned that they were disproportionately used by higher socioeconomic groups when compared to the more disadvantaged groups in society. It had devised programmes such as its ‘Energy Best Deal’, where it was working with the Citizens Advice Bureau to help consumers on a one-to-one basis to switch suppliers. Collective switching was also another medium that encouraged people to switch supplier. Ofgem was keen to ensure that a further derogation from the four-tariff rule that could be applied to collective switching exercises. It was also checking whether the rules concerning intermediaries in the Confidence Code could be used to ensure that people were confident that they were participating in a collective-switching exercise, and that it was conducted according to independent principles expected from an accredited switching body.

48. The push to maximise competition had to be balanced against the needs of those who were genuinely unable or unwilling to engage in the market. Ofgem had statutory obligations towards certain categories of customers and it was important to protect these in a way that caused the least distortion to competition.

49. Ofgem would have concerns about any actions that it undertook for customers that distorted completion on a wide-scale. Which? had proposed a single unit price for energy that allowed direct comparison with one figure of any tariff in the market. This would involve a standard standing charge for energy which would remove suppliers’ commercial freedom to set a standing charge. To achieve a nationally comparable price, regional differences would have to be removed between standing, and other, charges. Ofgem had considered Which?’s proposal during the formation of the retail market review remedies but had been concerned that such an approach could reduce competition and innovation in the market.

50. Ofgem said that overall satisfaction with the smaller suppliers was higher than with the larger suppliers. It did not believe that smaller suppliers were less appropriate for low-income customers because of any lack the customer
service infrastructure, and it did not have any evidence that smaller suppliers avoided low income customers. All suppliers had to offer payment methods other than direct debit to ensure those without bank accounts were not prejudiced in any way, and Ofgem had recently ensured that one particular supplier complied with this requirement.

51. Ofgem had unearthed no evidence that the regulatory regime was in any way stifling innovation in customer service, but it did believe that a stable, regulatory system was helpful for suppliers.

Switching

52. Levels of switching alone were a very poor measure of consumer engagement, and Ofgem was interested in the quality as well as the quantity of switching. It tracked consumers to understand whether they felt they received a better-value deal post-switch and, to date, there were encouraging signs that this was the case. Around 50% of people switching moved to independent suppliers, who currently offered the most competitive deals.

53. Ofgem had recently amended its statutory information requests that it made to the supplier communities so that it could track the switching between payment methods and tariffs with the same supplier and this would become part of its ongoing retail market monitoring.

54. It was important to consider switching in the round, taking into account a number of other metrics. There had been a drop in switching from the peaks of 2008 to 2009, but there was a lot of evidence that suggested the switching that occurred at this time was of poor quality. The UK had one of the highest switching rates in Europe, but Ofgem did not believe that this demonstrated that competitive pressure was exerted on the incumbent suppliers.

55. On the demand side, customer satisfaction, the general quality of service and trust were absolutely essential for an engaged and empowered consumer. On the supply side, key indicators included market share and liquidity.

56. PCWs were increasingly used as a vehicle for engagement, in part the result of technological developments. It was important that people trusted PCWs and there was a confidence code in place to accredit websites.

57. Ofgem believed that the level of confidence in accredited PCWs was very high. The standards set by the confidence code were more exacting than comparable codes in industries such as housing and car insurance. Energy PCWs were required to be independent of the suppliers, ensuring that there
was no cross-ownership. The prices that were offered to consumers could also not be influenced by any commission arrangements.

58. Ofgem would like it made much clearer to consumers that the deals they saw under the option ‘the deals you can switch to today’ were effectively only those that the PCWs earned a commission from. It had consulted on proposals to make this clearer, but it was currently not minded to require a default where consumers would see a whole-market view of available deals. It also did not see a role for itself in creating and owning an industry-wide website.

**Smart meters**

59. Ofgem believed that the introduction of smart meters would have a positive role in improving competition. They would provide greater surety to consumers regarding usage and a degree of innovation with regard to tariffs, particularly for time-of-use pricing, which could drive down both peak and overall demand and lead to savings for consumers.

60. The roll-out of the smart meters was unique in Europe in that it was supplier, rather than distributor, driven. For those that managed a timely and successful roll-out, it could benefit them through increased market-share in the long run.

61. Not all suppliers were positive about smart meters and Ofgem would have an explicit enforcement role under the smart meter licence conditions. It had requested that suppliers share their roll-out plans as the market moves towards the introduction of smart meters and this would enable Ofgem to identify and encourage those parties who fell behind with their preparations. Past experience had demonstrated that it was important to identify what companies were doing as early as possible and from the roll-out of smart metering for the small business sector it had a good insight into the preparations needed and timescales.

62. Smart meters were not a panacea for all of the ills of the energy market, but one of the potential benefits was faster switching, which it was hoped would have a positive effect on competition. But smart meters would not deliver this on their own. There would need to be a radical overhaul of industry systems and processes for data flows if one-day switching was to be achieved.

63. Smart meters could enable consumers to take control of their home energy usage, delivering both major benefits and shaking up the market. It would be many years before Ofgem had evidence as to their effectiveness and it was vital that the market functioned to encourage their success. To this extent,
derogations were available from the four-tariff rule that would allow innovative tariffs such as time-of-use charging.

64. Smart-metering and time-of-use charging had the potential to make energy usage expensive for vulnerable customers during peak-usage times and it was important that the push for competition had mechanisms in place to deal with this, otherwise smart meters could become a problem rather than an opportunity.

Micro-businesses

65. Ofgem witnessed vigorous competition in the non-domestic market, even in the small and micro-element of it. Independents challenged the market share of the incumbent suppliers and there were higher levels of customer satisfaction and more engaged customers than witnessed in the domestic market.

66. However, some micro-businesses had characteristics that were similar to domestic customers, such as similar levels of spend and dissatisfaction and disengagement with the market. Very small businesses tended to be on fixed-term deals and though this should serve as a prompt to engage in the market, research had shown that many micro-businesses roll-over their contract or stay with the same supplier.

67. Lobby groups and industry bodies that represented micro-businesses had felt aggrieved that they did not have the backstop protections afforded to domestic customers.

68. Ofgem’s approach to regulating this sector was to focus on information remedies, avoiding restrictions on, for example, the number of tariffs. It looked forward to receiving the outcome of the CMA’s investigation, particularly in determining the level of protection that should be given to micro-businesses.

Complaints

69. Ofgem said that there was some startling data and persistent trends with regards to consumer complaints and satisfaction levels. Satisfaction levels were in decline since 2008, with a 10% reduction in overall satisfaction and the level of customer complaints to suppliers had doubled since 2011.

70. There were specific requirements on suppliers with regards to handling complaints, particularly with regard to processes for registering complaints and informing customers about the energy ombudsman service. The requirements provided very specific metrics that enabled Ofgem to establish
whether a supplier was compliant with the complaint-handling requirements. Ofgem could fine companies for poor-complaint handling and had two cases ongoing. One of the cases was a new departure for Ofgem as it was applying the standards of conduct to an enforcement action for the first time.

71. There was a disparity with regard to poor performance and complaints among the largest firms and also these and the independent suppliers. Ofgem was trying to increase consumer confidence and had signalled that it would levy strong fines for mis-selling and other practices.

**Profitability**

72. The competition assessment undertaken by Ofgem looked at supply profitability in total profitability for the six largest vertically integrated firms. It found that overall profitability had risen, generation profitability had fallen, but supply profitability had risen very considerably. It was difficult to determine what had driven this outcome.

73. The larger suppliers had said that their level of profitability had risen from unsustainably low levels, which was true if you looked at supply profitability in isolation. In 2007, there was high levels of profitability in generation, with supply probably loss making. The loss-making was partly due to the larger companies getting their purchasing strategies wrong and partly due to the fact that because generation was sufficiently profitable, there was a lack of focus on the performance of the supply business, particularly if your return on capital was sufficient in the context of the integrated company. Market conditions in supply were unfavourable in 2007 and 2008 and this also witnessed a number of small-supplier bankruptcies.

74. Generation profits had decreased as a result of the overall movements in input costs, particularly the price movement of coal and gas. However, at the same time, supply profits had increased, possibly suggesting a lack of competitive constraints in the retail market to some extent.

75. It was very difficult to determine an acceptable level of profitability, but a further consideration might be to look at whether the better-performing companies earned higher profits.

76. Ofgem’s decision not to include the trading businesses of the large suppliers in the Consolidated Segmental Statements was due to the fact that they were not regulated businesses and for some it was difficult to separate out their GB activities from their activities elsewhere in Europe. Ofgem did not have the same legal framework to require companies to demonstrate the same level of transparency regarding its trading activities as it did with regard to generation
and retail. An independent review commissioned by Ofgem had also demonstrated that the transfer-pricing arrangements operated by the larger suppliers adhered to international rules.

77. The lack of transparency regarding the trading arms of the larger suppliers negatively impacted on public perception. Ofgem was interested to see the results of the CMA’s comparison of the profitability of the generating arms of the six largest suppliers, while having regard to the fact that they had two or three different models of how their trading arms were used, which could impact on a comparison of profitability between the companies.

78. Ofgem believed it had been successful in making the financial results of the largest suppliers more transparent, particularly with the consolidated segmental statements and the transfer-pricing methodologies they used. It hoped that this would provide reassurance regarding the energy companies’ financial probity. Investigating the trading arms would necessitate adopting a more intrusive approach and would involve cutting across national boundaries, investigating areas it did not regulate, which could be counter-productive.

79. Ofgem had its own notional hedging model that it used to produce the supply market indicators. Through its model it found that there was very little difference between the weighted average cost of energy it calculated and that which was being reported and it did not believe that an issue with transfer-pricing existed.

80. Ofgem’s intention in requiring companies to publish segmental statements was to ensure that the financials of those companies not listed on the UK Stock Exchange were on a comparable basis with UK listed companies. Ofgem believed it was more problematic if further disclosure was required in addition to normal financial reporting.

81. Supply market indicators were intended to demonstrate a degree of transparency. They were intended to demonstrate the average margins achieved by an average firm and the transparency was inherently valuable. Two qualifications for these indicators were that they were almost certainly not going to be right ex-post as they were forward-looking indicators. They were meant to fulfil a task of monitoring the market and providing information to consumers about trends in the market. This was their core function and they were not for providing detailed information for the companies or new entrants.

82. Other caveats that have been raised regarding the indicators, was whether in a market where Ofgem had clearly indicated that it saw at least an issue vis-à-vis coordinated effects, they were facilitating those effects. Ofgem believed
this was not the case because all of the information was essentially public
information that could be used by any firm. A further criticism was that
because they were not accurate they might provide an inflated projection of
profits, which served to fuel this lack of trust and political interest in energy
prices. Ofgem believed that if it did not publish these indicators, other parties
would, and they might publish more inaccurate data, given that Ofgem was
privy to the most accurate cost information in the energy market.

83. Despite the criticism they received, Ofgem believed the indicators were a
valuable tool for a regulator to provide information, particularly in a market that
provided an essential service. The negative reaction from the energy industry
in particular had used a very unconstructive argument that the indicators were
wrong because they did not forecast profits, when they were intended to be
used for purposes other than this.

Barriers to entry / expansion

84. Since the start of 2014, the energy market had witnessed significant
expansion from new suppliers. Over the last two years, new entrants had
increased their market share from 2% to what is actually now 8% and some
indicators were saying closer to 9%. New suppliers accounted for about 50%
of the switching and the big companies would view this in light of the fact that
independent players were exempt from some of the social and environmental
costs, which puts them at an advantage. Whilst they did have some
advantage from those exemptions, it was difficult to put their market growth
down to the fact that those social and environmental obligations were borne
by the incumbent suppliers. There were seventeen independent suppliers in
the domestic sector and more in the non-domestic sector.

85. Specific explanations for the growth of new suppliers included the transfer
from one of the incumbent suppliers of some of their customer base to a party
they had previously had a white-label deal with who then became accredited
as a supplier in their own right. This could not explain the upward trend
tirely and Ofgem believed this was also the result of a combination of new
suppliers genuinely offering some good deals and the bad press around the
incumbents. It was hoped that some of that increase was down to customers
being in a better position to identify a good deal rather than having obfuscated
tariff offerings.

86. One of the largest barriers, which had been the cited for a long time, was
credit and collateral, which took two forms: the credit and collateral needed to
trade or the credit and collateral that a company had to post as part of the
industry code arrangements. The latter was an area Ofgem, jointly with
DECC, was working on. They were particularly looking at credit and collateral
arrangements related to the use of the distribution and transmission systems. Ofgem was keen to understand where these requirements were inefficient and had a far too risk-averse assessment been taken of all of these different risks materialising at the same time.

87. Ofgem was attempting to address the trading collateral arrangements through its liquidity reforms. The Supply Market Access rules require the large companies to be transparent in their dealings with the companies about the reasons for the credit terms that they are offering them and if those reforms really did start to have a positive dynamic effect on the market, you might see more of the financial players coming in and helping with some of the access to better credit lines for the independent participants.

88. For a new business trying to get established in the energy sector, the sheer resource cost of dealing with all of the industry codes and the whole field of regulation, was possibly even more complex and burdensome than the more measurable collateral balance sheet-type costs. The governance mechanisms of some codes may have meant that the largest companies have the highest degree of influence. These companies had the infrastructure in place to understand them, to be able to have a view on what was best for them and so on and this may have acted as a barrier to entry and was certainly an uneven playing field.

89. The sheer complexity of the code system and the knowledge imbalance between incumbents and new entrants could potentially allow incumbents to act to delay changes to the codes that would assist new entrants.

90. Vertical integration and sticky customers were also factors Ofgem identified as barriers to entry and though Ofgem was relatively agnostic on vertical integration, it was looking for the CMA to assess its overall effect on competition in the market. With regard to inherently sticky customers, it was possible that energy was different from other markets. The degree of geographical spread in the market might suggest this. Ofgem was doing all that it could to reduce switching costs as it believed they were higher than they ought to be.

91. Ofgem’s ability to address barriers to entry arising from the codes was limited by two factors. One was the fact that the industry, not Ofgem, controlled the code modification process. This was intended to avoid too much regulatory intervention. Ofgem did have powers to take Significant Code Review action, which allowed it to step in to address particular issues where it considered the industry was not going to devise an appropriate solution, or where coordination across a number of industry codes was necessary. The changes
to electricity cash-out introduced as part the Electricity Balancing Significant Code Review was one example of such a process.

92. Ofgem said that unless there was effective buy-in from the industry that it needed to be done it would be quite hard for Ofgem to start a fundamental review of the whole code structure. If the CMA reached a conclusion that the codes were a barrier, a clear statement to this effect would be helpful as would giving clear recommendations that Ofgem should intervene to address the problem.

Concluding remarks

93. Issues such as the ramifications of vertical integration and the structure of the wholesale market had received much comment from the media and political commentators. Ofgem hoped the CMA’s investigation would focus on identifying whether perceived problems did or did not exist, and it looked forward to the results of the CMA’s investigation.