

ENERGY MARKET INVESTIGATION

Summary of hearing with Centre for Competition Policy (CCP) of the University of East Anglia on 2 December 2014

Nature of competition in the energy market

1. The energy market was perceived to be different from other markets by the public and politicians. It differed from most other markets in two ways. First, as a product, energy was homogenous in that the energy supplied by one company was no different from that supplied by another. Second, everyone had to purchase energy, and it took up a greater proportion of the incomes of low-income consumers, which meant that increases in energy costs had political implications.
2. Apart from the aspects noted above, it was not clear that the energy market was different from other markets. It had been privatised, and there was still an active lobby of people who disagreed with its privatisation and still did not agree with the introduction of competition in energy supply. In terms of consumer activity, it was not clear that the energy market's performance was much worse than that of other markets. Indeed, there were markets, such as current bank accounts, which performed less well. There were several factors to consider when identifying the appropriate level of consumer activity. The number of consumers who switched supplier was only one of these. The demographic characteristics of those consumers who switched and those who did not and the quality of their decisions were also important.
3. Price competition in energy did not operate in the way it did in other markets with homogenous products. In most other such markets, products were bought and sold through auctions or other similar processes. Because of energy's homogeneity, it was arguable that if the market really worked well and customers were highly responsive, then competition would be extremely intense and prices would be very close to marginal costs. If this was the case and if energy suppliers also had to cover fixed costs, then it might be difficult for more than one firm to operate in the market. Of course, this was not the current situation. There were six major energy suppliers and a number of smaller ones, including a set of new entrants, so there must be reasons for this. It was noted that the CMA had included two potential reasons in its issues statement. One was that the homogeneity of energy as a product assisted firms in tacitly colluding and maintaining prices at a level which

covered their fixed costs. The other reason the CMA had identified was consumer inactivity, which would mean that there were enough customers who did not switch and that the firms relied on these customers to cover their costs and provide their profits. As well as the reasons the CMA had identified so far, there were some other possibilities. For example, energy could be bundled with another, more profitable, product to create a more heterogeneous good.

4. There were other ways in which energy differed from other markets. Consumers did not know how much energy they would use in future, they only knew what they had used in the past. Also, since energy prices fluctuated, buying energy was more akin to purchasing a financial services product where returns were uncertain than buying physical consumer goods.
5. One reason why competition in the market might not work as well as it should was the lack of consumer engagement and activity. While collusion between firms was possible, if the homogenous nature of the market meant that there should really only be one firm if competition worked well, then each firm would have a strong incentive to disrupt any such collusion in order to gain more customers, increase its profits, and ensure its survival. It was noted that there had been no significant consolidation amongst the major suppliers since 2002 /03. This might be due to a view that any further consolidation by acquisition would not be permitted by the regulator or the competition authorities. Following the last round of consolidation, there was some evidence that competition between the major suppliers had reduced since there was less prospect of further consolidation. As far as competition between firms leading to some increasing their market shares and driving out the less successful firms was concerned, this was dependent on consumers' engagement and willingness to switch provider. If consumer engagement was low, then it would be difficult for the firms to compete in this way.
6. It was noted that the energy market was not static. There were a number of independent suppliers which now accounted for 10% of the market, and the overall market was shrinking as consumers, assisted by energy efficiency measures, used less energy. What was not clear was whether the independent suppliers had only attracted those consumers which had always been actively engaged in the market, or if they had managed to acquire previously disengaged consumers. If the former was true, then the six major suppliers would still retain their base of non-switching customers and could raise prices for those customers.
7. Suppliers could potentially differentiate between consumers in a number of ways. They could offer different tariffs based on a range of consumer characteristics including whether a customer was active or inactive based on

that customer's history and could potentially market tariffs in a way that would make them more attractive to some groups than others. A firm's ability to do so would depend on how much information about an individual consumer it had. It would also depend on whether there was so much variance between consumers that this data would be meaningful in determining whether an individual consumer was likely to be active or not. Some suppliers, particularly 'white labels' advertised on the basis of better customer service and used this to attract particular groups of consumers, though such claims are not always easy to verify.

Consumer behaviour

8. There were a number of factors that made consumers more or less likely to switch. The CCP had researched this, and while it had been relatively straightforward to obtain information from actively engaged consumers, it was much harder to do so from disengaged ones, so it was not possible to say that the factors which drove behaviour for engaged consumers were the same as those for who were disengaged. The CCP's research indicated that among active consumers, the gain they expected to achieve by switching was the most important factor, and that they were generally not deterred by the time taken to search, but might be deterred by expected switching time. What was unclear was how consumers made searching and switching decisions, and whether considering switching led to consumers searching, or whether consumers first decided to search and then considered switching. The CCP suggested that the CMA should look at the level of savings consumers expected to achieve and how this affected searching and switching behaviour. CCP's own research suggested that if consumers thought they could save around £120 per year, then the switching rate rose sharply to around 40% from less than 10% for savings below £20; however, it only rose by around another 10 percentage points when the potential saving rose to £350 per year. This suggested that some consumers were more sensitive to price than others. The CCP also suggested that the CMA should look at whether consumers knew how much energy they were using and how much they were spending. CCP's research indicated that consumers who used less energy thought they used more than they did while those that used a lot actually thought they used less.
9. The introduction of smart meters could have a major effect on consumers' knowledge of their energy use and on their behaviour. However, given the current level of consumer disengagement, smart meters would have to be made very attractive for consumers to use, or better yet, would need to be able to talk directly to appliances. As well as providing consumers with more information about their energy use, smart meters could also be used to

provide consumer information to suppliers. This could have both positive and negative consequences for consumers as it would potentially enable suppliers to identify the most attractive consumers and offer them better deals while allowing them to offer worse deals to unattractive consumers. It was not clear whether smart meters might allow radical changes to how consumers purchased energy to occur. For example, one way of changing the market might be to allow consumers to buy a set quantity of energy in a similar way to how they currently purchased petrol.

10. It was not clear how many consumers used the threat of switching to obtain a better deal from their energy suppliers and whether increased searching activity or switching activity would be of more concern to suppliers. It was noted in the report about the Big Switch project that consumers were more likely to switch when their current supplier approached them (in an attempt to persuade them not to switch to another supplier).
11. There were a number of reasons why consumers did not engage with the market. Consumers had limited spare time and might choose to spend it on activities other than switching their energy supplier. Also, consumers might decide to switch products which would have a greater financial impact for them, such as their mortgage, rather than their energy. Making switching energy supplier simpler should increase consumer engagement and switching levels. However, it was noted that the information consumers were required to provide to switch (after obtaining a quote) in the Big Switch project was very simple, yet only a third of participants who received a quote which offered positive savings actually did switch, so there seemed to be some other barrier to switching. It was noted that unlike the commercial market, there were no brokers in the domestic market, who would find out what the best deal for a consumer was and then handle the switching process.
12. Consumers tended not to talk to each other about saving money on energy in the way that they did about, for example, petrol prices. This might be because energy was simply less interesting to consumers than petrol. However, it might be because it was difficult, due to the relative lack of transparency of energy prices, for consumers to know whether they had obtained the best deal, and people did not like to appear foolish. If energy prices could be made more transparent, for example via smart meters, and consumers became more interested in and confident about talking about energy, then levels of engagement might improve.
13. It was noted that consumers might be naturally risk-averse and worry more about what they might lose by switching than what they might gain. The CCP had undertaken research a few years ago which showed that while most consumers who switched did save money, a significant number did not obtain

the optimum deal or were actually worse off. It was likely that the increased use of price comparison websites (PCWs) had improved this situation, so that more people who switched were getting better deals. It might be the case that PCWs were mainly being used by those consumers who were already engaged and active, and it was not clear that PCWs were encouraging consumers who were disengaged or dubious about switching to become more engaged. The services offered by the PCWs were available to those consumers who could access the internet.

14. It was difficult to say whether collective switching schemes would have a significant impact on the market. There were a number of issues with how these schemes were designed and operated. Ideally, if a large enough group of consumers took part in such schemes, then this would give them buyer power which would assist the scheme organisers in obtaining better deals when negotiating with energy suppliers. Schemes also needed to be properly marketed, and partnerships with trusted bodies such as the Consumers' Association (aka Which?) and local councils appeared to encourage consumer engagement. There was also the fact that in Great Britain, all collective switching schemes had so far been opt-in schemes, where consumers had to actively choose to participate in the scheme and agree to be switched. This was contrasted with the opt-out schemes which had been used in some parts of the USA. Under these schemes, a local authority would vote on whether to switch everyone in its area to the supplier which won an auction. The local authority would then conduct an auction in which energy suppliers would bid to offer the best price. Individual consumers had the right to opt-out of the scheme if they did not want to switch. For suppliers, an advantage of the opt-out scheme was that the winning energy supplier was more likely to receive a block of consumers, compared to an opt-in scheme.
15. The operation of opt-out schemes presented a number of questions: Should they be organised at a national or local level? Would there be enough consumers choosing not to participate in the scheme to sustain a market for rival suppliers? How many consumers should be involved in a single auction? (too few, and suppliers would not be interested, too many, and only large suppliers would be able to take part); and whether any disparities between consumers would simply move from the individual level to, for example, a regional level?
16. Introducing opt-out schemes in GB along the lines of the USA model might be politically difficult because local authorities and their constituents were unused to the idea of voting on these sorts of specific issues. Requiring consumers to switch unless they opted-out would also be unusual for GB. However, there were other groupings, such as social housing associations, where opt-out schemes might be more viable, though the housing association would need

the expertise to run the scheme. There were also issues about bundling housing and energy costs together, especially if such schemes were taken up by private sector landlords as well as housing associations.

17. There was a general perception that the fact that many energy customers were 'sticky', ie they had not switched energy provider, was a problem. Consumers needed to spend time and effort to switch energy providers, and it was possible that the level of stickiness was simply a reflection of this, so it might be better to think of stickiness as a phenomenon rather than a problem in itself. Judging the effectiveness of the market for consumers by levels of switching was not sensible alone, since if everyone in the market was on the best deal then the switching rate should be 0%. If switching was low and consumers were dissatisfied, then that would be a better indication of a problem in the market. While there was evidence that many consumers were not on the best deal for them, it could be argued that they were not switching because of the time and effort-cost involved or that they valued their current deal for some other non-price reason. The CCP had conducted surveys of energy consumers where they were asked if they would switch if they could save a certain amount of money. Often the consumers responded 'yes', but many of them did not actually go on to switch.
18. The CCP had made a study of the Big Switch collective switching scheme which had been run by Which?. As well as showing participating consumers how much they could save via the collective switch, Which? also told them if they could save more money by individually switching to a different supplier. The CCP's analysis showed that consumers who were shown two offers were less likely to switch than those who were shown one. Also it was important to note that the savings shown to consumers were potential savings based on their current energy consumption. For some consumers, it might be the case that for them to make the effort to switch, they had to believe that they would obtain the very best deal they could. This would require them to review the whole market which would take more time and effort than simply finding a somewhat better deal. While some other consumers, who simply wanted a better deal, would be happy to use collective switching services.
19. Following the introduction of the non-discrimination clauses by Ofgem, energy suppliers had responded by introducing a large number of temporary special offer tariffs. This result had been predicted at the time of the introduction of the non-discrimination clauses and the requirement that special offers had to be temporary meant that this was the only way the suppliers could compete for the customers they wanted to attract. It was unlikely that the proliferation of tariffs had been part of a deliberate strategy to confuse consumers so that they would be less likely to switch. If tariff proliferation in itself was perceived

to be a problem, this led to the question of what the right number of tariffs would be and how much consumers' choice should be constrained.

20. Switching energy providers could be an inconvenient process, and it was likely that consumers who did switch would remember how inconvenient it was and might be less likely to switch again. Switching problems had been reported by the media and these reports contributed to a negative perception of the energy market, which might lead to more consumers being discouraged from switching. It might also be the case that if switching was an inconvenient process; then if a supplier could poach customers from its rivals, it would likely retain them for a long period.

Unilateral market power and tacit collusion

21. If unilateral market power existed, then it would do so on a regional basis and involve the major suppliers' large market shares based on legacy customers on standard variable tariffs. If tacit collusion was present, then it should be occurring in the area of the market where there was the greater potential for competition, ie fixed term tariffs. However, the obvious mechanism for tacit collusion, price announcements, related to standard variable tariffs. The timing of price announcements was also regulated, and this needed to be taken into account when thinking about whether collusion was present. It was also good public relations practice for firms to make price announcements rather than just write to individual customers, as otherwise it would appear that the firms were trying to sneak the announcement past the media. Once a price change was announced publicly, it might be more difficult for a firm to go back on it, and it would also lessen the shock of the price rise for consumers when they received individual notifications.
22. If tacit collusion were to be present, its effect might be to discourage the six major suppliers from pursuing each other's legacy customers. However, if a supplier were to obtain a large number of legacy customers from another supplier it would need to ensure it had sufficient ability to obtain enough power to supply these customers. It would be interesting to look at the business market and see how it responded when a major customer moved supplier.
23. As far as the 'rocket and feather' phenomenon was concerned, firms would normally raise prices because of increased costs or increased demand. Raising prices did not enable firms to grow their market shares. If firms were colluding and wanted to keep their prices as close to the monopoly price as possible, then they would try to keep their prices as high as possible for as long as they could; but the fact that the prices would ultimately fall would

suggest that they were not very effective at colluding, or that the downward pressure on prices came from the threat of regulation or poor public image.

24. Previously, the presence of independents had had little effect on the six major suppliers, but the independents' share of the market had been growing, it was now approximately 10%, and the overall market was declining, so the independents were likely to start hurting the six majors, although their growth was only occurring in the fixed term market, where the active consumers were, and not the variable one, so their actual impact might be less than their market share implied. It was not clear how well the independents would fare if the vast majority of consumers were suddenly to become active and competition was to intensify. Also, there was the possibility that if the wholesale price were to increase significantly, then the independents would find it hard to stay in business.
25. The recent growth of the independents suggested that various concerns that certain business practices of the major suppliers gave them an unfair advantage over independents were not strongly founded.

Regulation

26. There had been a good deal of competition between energy suppliers at the start of the energy market as they were concerned to ensure they had enough customers to survive in a market which was consolidating. Competition continued to occur following the market's consolidation. The competitive process enabled the suppliers to find out about the costs of serving different types of consumers. During this period energy prices were falling, so there was little outside interest in the market and relatively little regulatory intervention. However, when energy prices began to rise, political and regulatory interest in the energy market did as well, and there was suddenly a feeling that there might be problems with competition in this market. Ofgem sought to address these potential problems with a range of interventions, some of which were successful and some of which might actually have been counter-productive. Energy price increases had occurred for a whole range of reasons. The real question was whether they were going up more than they needed to because of a lack of competition. However, price increases were of great political concern and this had led to interference which might have resulted in the market working less well.
27. Ofgem's Retail Market Review reforms were likely to be more pro-competitive than its earlier non-discrimination clause reforms. Simply reducing the number of tariffs would not necessarily make the market easier for consumers to navigate. The problem with trying to mix competition and regulation was that there was the potential for unintended consequences. It would be better to

simply decide to have either a competitive market or a regulated one and then to accept the consequences of that choice. However, making such a choice was not likely to be politically acceptable at the present time. The desirable balance between competition and regulation would vary over time depending on the political objectives the market was intended to achieve. If efficiency was the objective, then competition was the best tool; if affordability was the objective, then regulation might be necessary.

28. Currently, it appeared that the presence of the engaged consumers did not affect the group of disengaged consumers, either as to levels of engagement or the prices they received. It might be worth considering whether the market could be split into these groups, with a competitive market which engaged consumers could participate in and a regulated one for disengaged consumers. For this to work, it would be necessary for consumers taking part in the competitive market to be capable of getting better deals than those in the regulated market.
29. The initial proliferation of tariffs, which the Retail Market Review reforms had been intended to address, had occurred largely because of the introduction of the non-discrimination clauses. Suppliers had been forced to compete through temporary fixed tariffs. This had led to concerns that consumers who went on to fixed tariffs were unaware that they would move on to variable tariffs once their fixed tariffs expired, so Ofgem had sought to address this issue as well. It could be argued that every time Ofgem introduced a regulation, the suppliers' response would lead to another issue which Ofgem felt the need to address.
30. For competition and consumer engagement in the market to be improved, there needed to be a more credible threat that consumers would switch energy supplier. This would not necessarily require large numbers of consumers to switch, but suppliers would need to feel under pressure that they might if suppliers did not keep their offers competitive. Currently, it seemed that many consumers had given up on this market, and if the energy suppliers thought that was the case, then there would be little reason for them to compete. Assessing levels of consumer engagement was not straightforward, and it might also be the case that there was an upper limit to the level of consumer engagement in this market. There was evidence that consumers were motivated to engage and switch by the possibility of obtaining large savings, but for this possibility to exist there had to be large variations in prices, which meant that some consumers would have good deals and some would have bad ones. This was how markets worked, but this appeared to be politically unacceptable.
31. Internal switching might or might not represent competitive pressure. It depended whether the internal switch was triggered by a consumer's

knowledge of an offer from another energy supplier or not. However, internal switching might lead consumers to then become more engaged and aware of other suppliers' offers.

32. Ofgem's Code of Conduct for PCWs was a positive development, but most consumers did not know that it existed. There was some evidence that there were trust issues about PCWs and how they operated. One way of solving this problem would be to have an 'official' PCW approved by, although not necessarily run by, Ofgem. This official site would be paid for by all consumers and would not charge commissions, so consumers might trust it more than the current sites. It was important to note that PCWs could only make money if there were variations in energy prices. If they were too successful, so energy suppliers all offered very similar prices, or if consumers felt better able to compare prices themselves, then the PCWs' current business model would no longer be viable.
33. Alternatively, it would be useful if a mystery shopping programme could be regularly carried out to monitor how PCWs operated and check whether they produced correct results. There was a danger with PCWs that energy suppliers would create tariffs which very few customers could actually buy but would enable the suppliers to appear to have one of the best available tariffs, which could give consumers a false impression of these suppliers' competitiveness. PCWs ought to be able to filter results by whether they would receive commission so long as consumers were aware that this was the case.
34. It might be helpful to consider whether the best way to increase consumer engagement was to try to make those consumers who were already engaged even more so or to try to engage those who were currently disengaged. There were probably several reasons why disengaged consumers were disengaged, and it was not likely that one measure would address this problem.
35. When consumer groups and energy companies expressed concerns about there being a lack of trust in the market, it was not clear exactly what 'trust' meant. Consumers in any market should always adhere to the concept of 'buyer beware' and be careful when buying goods and services from suppliers, and the energy market was no different in this respect. Consumers probably did not think that energy suppliers were lying to them (and breaking the law in doing so), but they found it difficult to know when they purchased energy whether they were getting the best deal available at that moment or whether there would not be an even better deal available tomorrow. This uncertainty might simply mean that the market was working, but it might also deter consumers from engaging. It was noted that there had been cases where even though consumers had been offered better energy deals, they

had chosen not to take them, and one possible reason for this behaviour was that consumers might believe these deals were too good to be true. However, this was not the only reason why consumers might decide not to engage in the market or switch energy supplier. There was some evidence that the most-engaged energy consumers were less trusting.