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Submission to the CMA

Incumbency in the retail energy market

This paper describes why incumbency may be having a negative impact on competition	From To Date	Ofgem CMA January 2015

1. Summary

1.1. The energy market is characterised by a significant proportion of 'sticky' consumers, who are unable or reluctant to shop around and switch to get a better deal. Whilst sticky consumers are not uncommon in markets, they are unevenly distributed across suppliers in the retail energy market. Most are with the legacy suppliers: those who had regional monopolies (or national in the case of British Gas) at the time the domestic energy markets were opened to competition.

1.2. We are concerned that this uneven distribution of sticky consumers – the 'incumbency effect' – is likely to have negative consequences for competition in the energy market, beyond what might be expected from the existence of sticky consumers alone. It may have limited the benefits of competition materialising for all consumers, whether in the form of prices, better service or improved innovation. It also creates barriers to entry and expansion for independent suppliers, who are only able to compete for a subset of consumers – active consumers. Vulnerable consumers are more likely to be sticky consumers and therefore particularly disadvantaged by weak competition.

2. Inactive consumers in the domestic retail energy market and the development of the market

2.1. The State of the Market Assessment 2014[1] found that the complexity of tariffs, the lack of clear information to facilitate comparisons, and lack of trust in suppliers and/or the market have all contributed to weak customer engagement.

2.2. The nature of energy itself may also deter some consumers from engaging in the market. It is homogenous, meaning that it can be difficult to differentiate between suppliers. Additionally there are few prompts to encourage engagement: two-thirds of consumers with the largest six suppliers are on standard 'evergreen' contracts, which do not provide a regular prompt to consumers to make an active decision over their energy supply.

2.3. But the presence of inactive consumers is not unique to the energy market. For example the CMA has also noted this feature in the personal banking sector. Inactivity may not in itself constitute an adverse effect on competition (AEC). If there are sufficient active consumers in a market, they can put effective competitive pressure on suppliers, which benefits all consumers and protects inactive consumers from poor outcomes.

2.4. When competition was introduced in 1998 the monopoly electricity suppliers held 100 per cent market share for domestic consumers in their region. Following a number of horizontal mergers the number of domestic suppliers, including the gas incumbent, fell to six over the following five years.

2.5. The six incumbent suppliers therefore inherited a stock of consumers; a large proportion of who have never engaged in the energy market or have only had limited interaction with it. The incumbents continue to hold a disproportionate share of these customers to this day. An example of this disproportionate share with incumbents are those

[1] Ofgem, OFT and CMA (2014), State of the Market Assessment, chapter 3, https://www.ofgem.gov.uk/ofgem-publications/86804/assessmentdocumentpublished.pdf

consumers on single fuel tariffs: on average, the electricity incumbents hold a 69 per cent share of single fuel electricity customers in their home region and the gas incumbent has a 72 per cent share of supply for single fuel gas customers[2]. By contrast, independent suppliers do not have such an incumbent customer base. Instead, they must win a share of the active customer base.

3. The impact on competition

3.1. The uneven distribution of active and inactive customers gives rise to barriers to competition that may be specific to the energy market. It results in incumbent suppliers facing weaker competitive pressure from consumers and creates barriers to entry and expansion resulting in weaker pressure from independent suppliers.

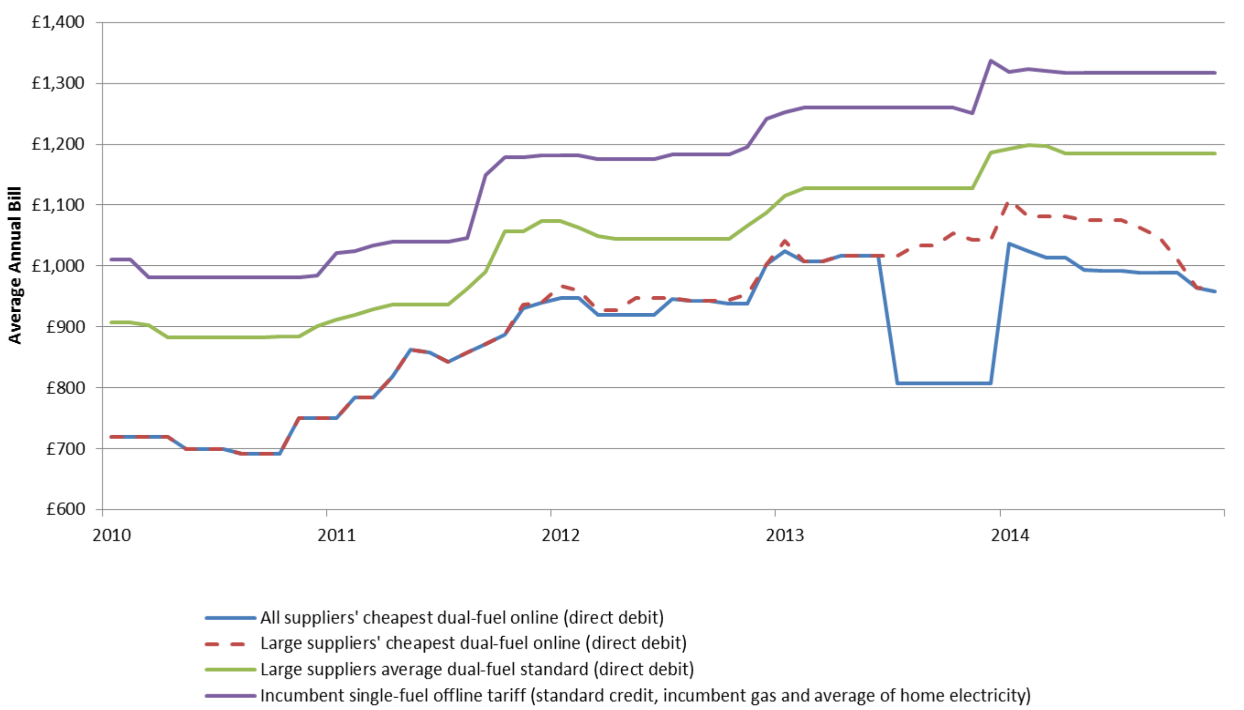
Weak consumer pressure

3.2. Segmentation is a common aspect of many markets. In energy, all suppliers are able to segment the market between active and inactive consumers and apply differential pricing strategies accordingly. Initially, all consumers were on single fuel evergreen tariffs with their incumbent supplier. Over time, suppliers have provided a range of discounted tariff types. For example the introduction of competitive dual-fuel deals, tracker and on-line deals have, at different times, resulted in the most active customers distinguishing themselves from the less active through their tariff choice. At the most extreme, incumbent suppliers were able to keep legacy customers on uncompetitive "dead" tariffs which were no longer available to prospective customers[3].

3.3. Most recently competition has focussed on the price charged for fixed-term deals. As shown on the chart below, dual-fuel customers of large suppliers on standard (ie evergreen) tariffs and those on standard single fuel offers pay more than those on fixed-term tariffs (ie cheapest dual-fuel online tariff). Most recent trends have shown an expanding differential between those on evergreen tariffs and those on the cheaper online fixed tariffs.

[2] Ibid, pg. 48
[3] This practice was prohibited by the Retail Market Review rules

Figure 1 - Comparison of prices of a selection of single-fuel and dual-fuel bills[4]



Source: Energylinx, Ofgem analysis

3.4. In December 2014 a consumer on a single-fuel tariff on standard credit with their incumbent supplier could save up to £350, 27 per cent, by switching to the cheapest online dual-fuel deal[5] and a consumer on an evergreen standard direct debit tariff with a large supplier could save on average over £200, 20 per cent.

3.5. The combination of a high proportion of sticky consumers in the legacy supplier customer base, the uneven distribution of sticky consumers between legacy suppliers and independent suppliers and the ability of suppliers to segment the market between sticky and active customers, weakens competitive pressure on the legacy suppliers. Because they can compete by providing competitive tariffs to their active consumers, without having to drop prices and worry about losing their sticky customer base, legacy suppliers are likely to have weakened incentives to take steps which might benefit all consumers such as improving customer service or improving overall efficiency.

Barriers to entry and expansion

3.6. The incumbency effect also creates barriers to entry and expansion for independent suppliers, who are only able to compete for a subset of consumers in the market. This further weakens the competitive pressure on the incumbent suppliers.

3.7. Independent suppliers' market share in electricity and gas has increased from 1 per cent to over 8 per cent in two years[6]. They are offering attractive fixed-term deals and competing for active consumers. The proportion of switches to independent suppliers is around 50% of total switches (in September 2014)[7].

[4] The sharp drop in the all suppliers' cheapest dual-fuel tariff from mid-2013 to end 2013 we believe is an outlier. The chart does not factor in any of the price reductions announced in January 2015
[5] In December 2014, based on Ofgem analysis using Energylinx data
[6] As at September 2014
[7] Data from Distribution Network Operators (DNOs) and Xoserve

3.8. This trend is positive, but it is too early to tell whether the growth in independent suppliers' market share will be sustained. So far the increase has occurred against a backdrop of benign conditions, including falling wholesale prices.

3.9. However, the large proportion of inactive consumers held by the incumbent suppliers can impose limits on the growth of independent suppliers. They are only able to compete for active consumers. The costs of acquiring such consumers are likely to be high, but the revenue they bring is inevitably lower because they are on more competitive tariffs. The resulting lower profitability of their customers is likely to pose a barrier to growth for independent suppliers.

3.10. Some independent suppliers also noted in their responses to the CMA's Issues Statement that incumbent suppliers were able to offer very competitive deals because they could cross-subsidise prices to new, active customers from those of their sticky consumers on higher-priced tariffs. These pricing strategies could deter entry and expansion. We note the CMA's intention to assess retail profitability of different customer groups and regions, and include the value of customer bases within its profitability analysis. We look forward to seeing the results of this analysis.

4. Further considerations

4.1. The adverse impacts on competition are particularly worrying because energy is an essential product with very few substitutes. The price and service levels associated with energy are a key public concern. Our research as part of our RMR monitoring framework[8] and engagement tracker surveys[9] show vulnerable consumers are disproportionately likely to be inactive consumers and therefore particularly disadvantaged by weak competition.

4.2. Ofgem has introduced measures, such as the Retail Market Review policies (RMR), to increase competitive pressure on suppliers by making it easier for consumers to engage in the market. The Cheapest Tariff Messaging, for example, requires suppliers to provide information on what the cheapest tariff is for an individual based on their current preferences across the supplier's range of tariffs. This is intended to provide a trigger for consumers to engage and could help overcome consumer inertia and reduce search costs. This could also constrain the ability of suppliers to segment between active and inactive customers.

4.3. Other developments, such as the introduction of smart meters, could further improve engagement of inactive customers in the future. However, all these measures will take some time to work. It is also unclear whether they will sufficiently increase the size of the active consumer base to constrain the behaviour of suppliers, and create a well-functioning energy market.

4.4. As noted above, there are inactive consumers in other markets. We believe it is the uneven distribution of such consumers that causes particular concern in the energy markets. Due to its cross-sectoral expertise, the CMA will be well-placed to further assess this view. For these reasons, we would suggest that this incumbency effect should be a key focus of the CMA's market investigation. We look forward to seeing the CMA's analysis on this point and are happy to provide any support that the CMA would find helpful.

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[8] TNS BMRB (2014), Retail Market Review Baseline Survey, https://www.ofgem.gov.uk/ofgem-publications/89113/ofgemrmrbaselinefinalpdf.pdf

[9] Ipsos Mori (2014), Customer Engagement with the Energy Market, https://www.ofgem.gov.uk/ofgem-publications/88375/customerengagementwiththeenergymarket-trackingsurvey2014finalpublished2662014.pdf