Mr Will Fletcher, Project Manager
Energy market investigation
Competition and Markets Authority
Victoria House
Southampton Row
London
WC1B 4AD
By email at EnergyMarket@cma.gsi.gov.uk

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Dear Will

Submission on Updated Issues Statement

1. In August 2014 we former GB energy regulators submitted a response to the original CMA *Issues Statement*. Until early 2008 the retail energy market had been hailed by Ofgem and international commentators as competitive and successful. We were concerned that the market was thereafter said to be seriously problematic. We therefore supported Ofgem's decision to make a market investigation reference to the CMA.
2. We also commented on a number of points made in the *Issues Statement*. In particular, we noted that there had been a change in Ofgem's regulatory approach in 2008 and suggested that the CMA explore the impact of this. We welcomed the CMA's intention to use a realistic assessment of market outcomes as a benchmark rather than an idealised notion of a perfect market. We stressed the importance of the CMA's investigation being independent of Ofgem. We recognised the need to take full account of the situations of vulnerable customers, and urged the CMA to investigate the reasons for the withdrawal of certain tariffs valued by such customers. And we invited the CMA to consider the concept of "fairer" prices that Ofgem has used to justify many of its policies.
3. We welcome the clarifications and development of thinking reflected in the CMA's *Updated Issues Statement*. For the most part it is consistent with the points we made in our submission. Although it is very preliminary, it offers the prospect of a valuable understanding of how competition in the domestic energy market is working.
4. There are now a few points that we urge the CMA to explore further in order to see the present energy sector in perspective – that is, to understand the extent to which customer, supplier and regulatory behaviour are similar to, or different from, how they used to be in this sector until 2008 and how they are in other regulated competitive sectors.

Conclusions

5. The *Updated Issues Statement*, taken together with the analysis and factual comparisons made in the present submission, suggests the possibility of a narrative along the following lines:

- compared to other competitive sectors, average energy price increases since 2004 *have been exceptionally high*, mostly for reasons beyond the control of the suppliers, which has understandably aroused great customer and regulatory concern;

- compared to other competitive sectors, customers are *not* exceptionally inactive in the energy sector, *nor* are available price differences exceptionally great;
- compared to other competitive sectors, supplier behaviour is *not* exceptional, since differentiation of prices (regionally or otherwise), increasing variety of tariffs, market segmentation and lower prices for more active customers are normal features of a competitive market, not indications of supplier misbehaviour, market power or a "broken market";
- compared to other competitive sectors, regulatory interventions in the energy sector since 2008 *have* been exceptional, with respect to detail, extent, severity and purpose.

6. The CMA notes that "among the main drivers of price increases over this period have been network costs and the costs of social and environmental obligations". (fn 7) It is for the CMA to assess how far the price increases are explained by such costs, and by external fuel costs, or by increases in profit, and in that latter event what impact regulatory interventions have had.
7. It seems possible that the exceptional regulatory interventions were spurred by the exceptional price increases. The interventions were intended to bring about "fairer" prices and/or a more competitive market. In the event, they had the unintended effect of reducing competition, increasing supplier profits and increasing prices to all customers, including those whom such actions were intended to benefit.
8. If the CMA finds any substance in this narrative, we hope that it will conclude that the removal or substantial relaxation of the present restrictions on suppliers would increase their ability to compete more effectively. This will be of value to customers generally, not least vulnerable customers. It also leaves open an important role for regulation in better facilitating access of vulnerable customers to the benefits of a competitive market, rather than limiting the ability of the competitive market to provide those benefits in the first place.

Overview of Market Outcomes

9. The *Updated Issues Statement* begins with an overview of some observed market outcomes, to provide context for the investigation of the theories of harm. It finds that average energy prices to domestic customers rose significantly over the period 2009 to 2013: by 24% for electricity and 27% for gas. (para 14)
10. It would be helpful if the CMA could put these energy price rises in context, by comparing them with price changes in the previous period, and with other significant elements of customer budgets over the same period. The CMA's Figure 1 suggests that the average dual fuel energy bill grew even faster over the period 2004 to 2008 than from 2009 to 2013. We believe that energy prices rose significantly faster than most other prices over both periods. If so, this could help to explain customer and media attitudes to energy suppliers, and could also help to explain the regulatory interventions over this period. Comparative figures for quality of service and complaints would also be helpful.

11. The CMA does make such a comparison with respect to customer attitudes. It reports that "evidence from the CMA customer survey suggests that domestic energy customers have a much higher level of trust that their own supplier will treat people in a fair and honest way than that other energy suppliers will treat people in a fair and honest way. Further, the results suggest that trust in other energy suppliers is considerably below that in other service companies, such as retail banks, car insurers and mobile network providers". (para 25) To give the full picture, the CMA might have added that the results also suggest that trust in customers' *own* energy supplier is considerably *above* those in other service companies such as retail banks, car insurers and mobile network providers.[1]
12. The *Updated Issues Statement* suggests that, with certain exceptions, updated theories of harm 1, 2, 3a and 3b – which include the market rules and framework (NETA and EMR), generator market power, liquidity and vertical integration - do not seem unduly problematic. It introduces a new updated theory of harm 5, related to code governance. In the retail market, attention and potential concern are focused on updated theory of harm 4, viz, that "energy suppliers face weak incentives to compete on price and non-price factors in retail markets, due in particular to inactive customers, supplier behaviour and/or regulatory interventions". We comment on these three factors in turn.

Inactive customers

13. The CMA's initial view is that a significant number of domestic energy customers are relatively inactive, and there are potential gains from switching supplier that go unexploited. (para 133) The CMA rightly recognises that this might not be a competition concern, if the costs and inconvenience of switching outweigh the benefits. It proposes to seek to understand the barriers to engagement and switching.
14. We suggested previously that the most realistic benchmarks for assessing the present GB retail market would be the same market before 2008, and other GB markets such as telecoms, insurance, financial services etc.
15. The average annual customer switching rate (churn) in the energy sector is about 10% now. But it increased from about 16% in 2003 to 20% in 2008. Over that period GB domestic energy switching rates were as high as, and mostly higher than, in any other energy market in the world.
16. The GFK NOP customer survey report for the CMA begins its summary of findings with the statement "There is a relatively low level of engagement in the energy market." (para 4) This is misleading. It seems to mean only that a small proportion of customers switched supplier compared to the proportion who were aware that they could switch. What is not reported in the summary of findings is that the proportion of customers who switched supplier in the last 3 years was 27% for energy, just over half the proportion for car insurance (54%) but greater than that for mobile phones (24%) and more than double that for mortgages and current accounts (both 12%).[2] This shows a relatively *high* level of engagement in the energy market.

[1] GFK NOP, *Report for the CMA*, para 52, Figure 5, p 12.
[2] GFK NOP, *Report for the CMA*, Figure 10, p 15.

17. This is consistent with experience in previous years. Ofgem reported the proportion of customers who switched provider over the 5 years 2003 – 2008.[3] Gas and electricity (both 54%) were less than car insurance (61%) but greater than home insurance (46%), fixed line telephone (44%), mortgages (38%), mobile phones (35%), credit cards (31%), savings accounts (20%) and current accounts (13%).
18. The CMA reports average gains from switching from an incumbent dual fuel Standard Variable Tariff to another Standard Variable Tariff to be between £111 and £153 per year. (para 134) Assuming an average dual fuel Standard Variable Tariff of about £1100 (Figure 1), this implies gains in the range 10% - 14%. The CMA reports average gains of £158 to £234 from switching from a dual fuel Standard Variable Tariff to a fixed tariff, which suggests a range of 14% - 21%.
19. This again is not inconsistent with earlier years. Ofgem reported that from January 2003 to July 2008 the former incumbent electricity suppliers charged on average 10% more to their in-area Standard Credit customers than to their corresponding out-of-area customers, with a differential varying at times and by supplier from 5% to 20%.[4] Ofgem reported the growth of fixed and other tariffs over the period 2003 to 2008 but did not report the relative prices.
20. A cursory review of internet sources today suggests that average savings from switching home insurance and motor insurance lie in similar ranges. In broadband and payTV the lowest prices (sometimes including introductory offers) represent an even greater discount on the higher prices. In the mortgage market, average standard variable rates are presently about 4.5% whereas five year fixed rates are about 2.5% and two year fixed rates below 2%.
21. We strongly encourage the CMA to make such comparisons in a systematic way. In any competitive market only a fraction of customers change provider over a given period of time, even though there may be a significant variation in the prices on offer from different suppliers: for various reasons not all customers choose the lowest cost supplier. As noted above, the CMA's survey shows that customers trust their own supplier more than others. Do domestic customers really behave significantly differently in the energy market than they do in other markets?

Confidence Code

22. As part of its discussion of inactive customers, the CMA rightly notes that third party intermediaries (TPIs) and Price Comparison Websites (PCWs) can provide a means of increasing consumer engagement. It says "Ofgem has decided to amend the Confidence Code such that PCWs will no longer be able to present as a default only fulfillable tariffs, and will be required to use a standardised methodology for estimating the savings from switching. We recognise the need to strike a balance between fostering confidence in the use of PCWs in retail energy markets and ensuring that PCWs have a commercial incentive to remain in the market and help improve customer engagement, and we would welcome views on whether Ofgem's recent decisions and proposed changes to the Code strike the right balance." (para 141)

[3] Ofgem, *Supply Probe*, 6 October 2008, Figure 4.3 para 4.4 reporting results of Ipsos Mori survey carried out for the OFT, July 2008.
[4] Ofgem, *Supply Probe*, 6 October 2008, Figure 7.4 and para 7.36.

23. It is an empirical question whether PCWs are able to remain in the market and invest in ever-improving methods of making and presenting comparisons that customers find understandable, informative and attractive, while providing details of all tariffs in the market, including of those suppliers that do not pay commission for switching. At present, it seems that many PCWs can do this, and have chosen to provide details of all tariffs.
24. Ofgem's standardised methodology for estimating the savings from switching is another matter. It has been strongly criticised – by various suppliers, PCWs and media customer advice columns - as misleading customers by overstating the potential savings from switching tariffs. (This is because the methodology requires the assumption that customers at the end of a fixed term tariff will default to the incumbent supplier's Standard Variable Tariff for the rest of the year.)
25. We believe that this criticism is valid. Rather than impose a standardised methodology that is potentially misleading, it would be preferable to allow suppliers and PCWs to develop their own ways of estimating and comparing savings from switching tariff. They could then tailor these comparisons to the different circumstances of the various types of customers that they deal with, in ways that are most understandable by those customers. Looking forwards, it seems unlikely that a standardised methodology, or indeed the concept of a standard variable tariff, will remain appropriate in an ever-evolving world of smart meters, increasingly differentiated tariffs and the possibility of automated switching according to trigger points of savings specified by the customer in advance.

Supplier behaviour

26. The CMA says that "elements of the evidence that we have reviewed to date appear to us at this stage to be consistent with the hypothesis that the Six Large Energy Firms have UMP [Unilateral Market Power] over their Standard Variable Tariff customers." (para 144) "… a substantial proportion of domestic customers are disengaged, which would tend to insulate suppliers from competitive pressures for those customers" (para 145) "We have observed that the Six Large Energy Firms have consistently charged higher prices for the Standard Variable Tariff for gas and electricity compared with non-standard tariffs, which provides some support for the view that these suppliers can segment the market and price discriminate." (para 146)
27. Market segmentation, price and product differentiation, and various kinds of price discrimination are characteristic of almost all markets, including competitive ones – perhaps especially competitive ones. Price discrimination can be competitive rather than monopolistic. Indeed, Professor William Baumol, a long-standing expert on US regulation, has shown that competition can force a company to price discriminate, simply to stay in the market.[5]
28. Even if a substantial proportion of customers are apparently disengaged this does not necessarily mean that suppliers are insulated from competitive pressures. Suppliers might be reducing their prices to marginal cost to attract additional customers. But if their overall return is low or about zero – which is

[5] William J Baumol, *Regulation misled by misread theory, Perfect competition and competition-imposed price discrimination*, 2005 Distinguished Lecture, AEI-Brookings Joint Center for Regulatory Studies, Washington DC, 17 March 2006.

essentially what Ofgem found on average in 2008 – this means they are far from insulated from competitive pressures, even for their less active customers.

29. The CMA has found that, although prices and margins vary between different types of tariff, and no doubt by firm, the six large firms' average profit rate (EBIT) on domestic customers over the period was 3.3%. (para 14) It is for the CMA to judge whether this was an appropriate or excessive level, whether it has increased over time and what might have caused any such change. However, it is this or some related measure of profit rate, rather than the level of market segmentation, price differentiation or customer (dis)engagement, that will indicate whether the six large energy suppliers have and are exercising market power.
30. We therefore urge the CMA to compare the extent of market segmentation and price differentiation in the domestic energy sector against practices in other sectors. It can then incorporate into its economic analysis this understanding of supplier behaviour and how competitive markets actually operate.

Regulatory interventions

31. The *Updated Issues Statement* explains (paras 119, 120) that Ofgem implemented Standard Licence Condition SLC 25A (prohibiting regional price discrimination) in 2009 and its Retail Market Review (RMR) reforms in 2013. The CMA says "Our initial view is that the history of liberalisation and regulatory decisions have had a strong influence on the nature and strength of competition between the Six Large Energy Firms." (para 131) Its Figure 1 shows the evolution of average Standard Variable Tariff bill against expected direct costs over the period 2004 to 2014. The CMA says "We note that Figure 1 above is suggestive of an apparent softening of competition in Standard Variable Tariffs from 2009 onwards (in that the gap between the average Standard Variable Tariff and total costs appears to widen since 2009) and that this broadly coincides with the introduction of the prohibition." (para 158)
32. These are important initial views, which coincide with our own perceptions. We welcome the CMA's intention to explore further the effect of regulatory interventions, using both qualitative and quantitative analysis. In addition to the examples it cites, the CMA will no doubt examine whether the higher prices for Standard Variable Tariffs compared with non-standard tariffs seem to have been stimulated by particular regulatory interventions.
33. As with customer and supplier behaviour, we urge the CMA to compare regulatory behaviour, both over time and in other markets. We have made the point that Ofgem policy changed significantly in 2008. Its interventions since then have gone significantly beyond what other UK regulators have done, in terms of detail, extent, severity and purpose.
34. Contrast, for example, the FCA's recent statement on regulation of the cash savings market.[6] The FCA has decided not to intervene by specifying the number or type of products that each provider should offer, or by banning introductory bonus rates, or by requiring firms to pay a single rate on all products of a specific type, or by requiring firms to put all their customers on

[6] Financial Conduct Authority, *Cash Savings Market Study Report: Part I Final findings, Part II Proposed Remedies*, January 2015, Market Study MS 14/2.3, at paras 9.111, 114, 115, 117.

to a single ‘best’ interest rate. Its reasons are that such regulatory interventions would have serious adverse consequences, including in terms of preventing some consumers from having products that meet their needs, stifling innovation, discouraging switching, and unintended or distortive consequences.

35. The FCA has emphasised the need for trialling possible regulatory interventions with a sample of suppliers and/or customers in order to assess their effects before deciding whether or how to introduce them for the market as a whole. This has provided valuable information and enabled the FCA to modify its regulatory approach. We invite the CMA to consider whether this would be equally appropriate in the energy sector.

Social objectives

36. As to going beyond other regulators in terms of purpose, our earlier submission noted that Ofgem has presented its regulatory interventions in terms of securing “fairer” prices. For example, SLC 25A was designed “to remove more than £500 million in unfair premiums from suppliers’ tariffs”. Ofgem envisaged that suppliers would increase prices to other customers by the same amount, in order to hold constant total supplier net income.[7]
37. Under RMR, present policy is still driven by this concept. “Standards of Conduct, backed by fines if necessary, require suppliers to treat their customers fairly. … The onus will be on suppliers to embed fair treatment of consumers in every level of their organisation. Any brokers or third party intermediaries that represent suppliers will also be bound by the standards of conduct.”[8] One of Ofgem’s “top priorities” is to “focus on what suppliers do to treat customers fairly”. “We believe in using general standards of conduct to make companies treat customers fairly. … Over time we hope to rely more on general standards of conduct rather than detailed rules about what companies can and cannot do.”[9]
38. What constitutes “fairness” is not explained. It seems that the policy is not “seeking *significant redistribution* of costs among consumers” but it is to “make sure that those who don’t engage are not *disproportionately* worse off”. (p 11, italics added)
39. The CMA’s *Updated Issues Statement* makes no substantive reference to these issues. Yet the policy raises important questions. Does Ofgem consider that over £500m is an insignificant redistribution of costs among consumers that does not make other customers disproportionately worse off? Or has its policy changed? Now that SLC 25A has been discontinued, do the standards of conduct still preclude suppliers from charging “unfair premiums”, or are such premiums no longer deemed “unfair”? This bears on the CMA’s investigation into whether suppliers are continuing to act as if SLC 25A is still in place. (para 160)

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[7] “Ofgem’s energy market probe is on track to remove more than £500 million in unfair premiums from suppliers’ tariffs, but Ofgem wants speedier action”, Ofgem Press Release R 35, 16 December 2008. “… the erosion of price differentials may be through a rebalancing of prices rather than by a straightforward decrease in price for the most impacted customers”. Ofgem, *Addressing unfair price differentials*, Ref 01/09, 8 January 2009, Appendix 2 para 1.7.

[8] Ofgem Press release, 27 August 2013.

[9] Ofgem, *Corporate Strategy Document*, 18 December 2014, pp 14, 16.

40. More generally, if "detailed rules about what companies can and cannot do" are replaced by standards of conduct, are suppliers liable to be required to take actions that would redistribute over £500m in other ways? How can suppliers know what Ofgem will deem "fair" or "unfair"? Importantly for the present investigation, what are the unintended consequences? Experience suggests that SLC 25A reduced competition and increased prices to customers, including to some vulnerable customers who had previously secured lower prices by being active.
41. There is no reference to "fairness" in Ofgem's statutory duties. Our earlier submission suggested that it would be helpful if the CMA were to consider whether, and if so how far, Ofgem has a statutory locus (a) to decide what are "fair" prices and (b) to impose them via licence conditions. The CMA's *Updated Issues Statement* suggests that SLC 25A did indeed affect the extent and nature of retail competition, and increased the gap between prices and costs. We now urge the CMA to address the "fairness" questions explicitly, looking not only at the specific SLC 25A and RMR regulatory "rules" but at the standards of conduct too.
42. Ofgem's statutory duties in fact relate to specified vulnerable customers, rather than to customers who for various reasons choose not to engage. There are alternative ways of assisting vulnerable customers that do not restrict competition. In the past Ofgem highlighted E.On's Staywarm tariff as one of the major initiatives to address the needs of the fuel poor. Tariffs with no standing charge are another example.
43. The CMA's *Updated Issues Statement* mentions the removal of two-tier tariffs (para 121), but not in the context of social objectives, nor is there reference to E.On's Staywarm tariff. We hope that the CMA will bear in mind the social importance of these and various other tariffs, and consider whether the restrictions on them – and on suppliers that particularly cater for vulnerable customers via prepayment meters - can really be justified. It would seem helpful to remove the necessity for suppliers to seek derogations from present restrictions in order to go into partnership with local authorities to assist vulnerable customers.[10]
44. More generally, we hope the CMA will give thought to how regulation can assist customers generally, and vulnerable customers in particular, to benefit from the competitive market. As smart meters develop in future, restrictions that hark back to a simpler era will be increasingly inappropriate as a means of stimulating customer engagement, new entry and innovation.

[10] "Ovo consider that the partnership will allow Peterborough City Council to provide more choice for consumers and better consider the needs of local people. They have indicated that Peterborough City Council will be able to design propositions that are more closely aligned with the needs of different local consumer groups, such as those in fuel poverty. They also consider that the partnership will increase consumer trust by allowing Peterborough City Council to engage with consumers who have low trust in the market as a whole but would have more trust in a local organisation to deliver benefits for their community." Ofgem, Request for derogation: Peterborough City Council Tariffs, 19 February 2015.

From:

Stephen Littlechild, Director General of Electricity Supply and Head of the Office of Electricity Regulation (Offer) 1989-1998

Sir Callum McCarthy, Chairman and Chief Executive of Ofgem and the Gas and Electricity Markets Authority (GEMA) 1998-2003

Eileen Marshall CBE, Director of Regulation and Business Affairs, Offer 1989-1994; Chief Economic Adviser and later Deputy Director General of Ofgas 1994-1999; Managing Director, Ofgem and Executive Director, GEMA 1999-2003

Stephen Smith, senior executive positions at Ofgem 1999-2002 and 2003–2010 including Managing Director, Markets, 2004-2007 and Executive Board Member, GEMA 2004- 2010

Clare Spottiswoode CBE, Director General of Gas Supply and Head of the Office of Gas Regulation (Ofgas) 1993–1998.