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Date: 27<sup>th</sup> of March To: Energy Market Investigation Team

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## Consultation Response

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### CMA Energy Market Investigation - Update Issues Statement

Which? is the largest consumer organisation in Europe with more than 800,000 members. We operate as an independent, a-political, social enterprise working for all consumers and funded solely by our commercial ventures. We receive no government money, public donations or other fundraising income. Which?'s mission is to make individuals as powerful as the organisations they have to deal with in their daily lives, by empowering them to make informed decisions and by campaigning to make people's lives fairer, simpler and safer.

The CMA's Updated Issues Statement has illustrated in more detail why the current GB energy market arrangements are not working for consumers.<sup>1</sup> As we set out in our initial submission and in our Evidence session, there are a number of factors that are driving poor outcomes in the retail market; for example, complex tariff structure, poor levels of customer service and low levels of consumer trust in the sector. The result is poor outcomes for consumers, particularly for the 75% of households on standard tariffs. As the Updated Issues Statement sets out, there is little, if any, competitive pressure on these tariffs and the suppliers have unilateral market power over these customers. This is not an acceptable outcome and a radical shift in the arrangements is required.

The analysis and thinking in relation to Theory of Harm 4 - the retail market is at an earlier stage. It is critical that in the next stage of its analysis of the domestic retail market, the CMA explore what arrangements will deliver the best outcomes for consumers. For example, while the number of people engaging in a market is important, more critical is the quality of the outcomes for consumers, both for those engaging and making decisions, and for those who do not. We provide detailed comments below.

The issues are not limited to the retail market. There remain questions about the dynamic between the different business functions within vertically integrated firms. We also provide comments on Theories of Harm 1 and 3.

<sup>1</sup> Energy Market Investigation - Updated Issues Statement, CMA, February 2015

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Ultimately, the success of the CMA's Energy Market Investigation and the proposed remedies is critical to creating an energy market that delivers for both consumers and industry. Which? believes that reforms to the retail market should include the introduction of Simpler Pricing and a Price to Beat. We provide further information on both of these proposals in the Remedies section below and in the annexes.

In total we provide the CMA with four annexes to support its analysis and the development of remedies:

- 1) Which? proposals for competition in Contracts for Difference allocation
- 2) A Price to Beat: achieving a balance between competition and consumer protection in the retail energy market (confidential)
- 3) Simpler Pricing behaviour research
- 4) Which? analysis: Energy wholesale costs and retail prices

### **Comments on the Theories of Harm**

#### **Theory of Harm 1: the market rules and regulatory framework distort competition and lead to inefficiencies in wholesale electricity markets**

##### **Quality of wholesale price information**

As the CMA is aware, Which? has raised concerns regarding the quality of information - specifically the reliance by price reporters on human reporting rather than transactional data.

<sup>2</sup> The Updated Issues Statement sets out that the evidence the CMA has reviewed to date does not suggest that prices are opaque in the wholesale electricity market for participants.<sup>3</sup> The Liquidity working paper also sets out that while the majority of trading continues to be Over the Counter (OTC) that this is now primarily done through the Trayport platform.<sup>4</sup> This in theory should mean that price indices are increasingly compiled from transactional data, relying less and less on human reporting. We would welcome clarification from the CMA that this is indeed the case, together with a more detailed breakdown of what volumes - monetary and mwh - are traded and used to compile price information across the different systems.

##### **Electricity Market Reform - Contracts for Difference**

In 2013 we published a report '*The Imbalance of Power: The Challenge of Decarbonisation*',<sup>5</sup> which provides more detail on our views of the Electricity Market Reform. On Contracts for Difference (CfDs), Which?'s position is broadly aligned with that of the CMA: the move to CfDs should deliver better value for consumers.

However, in order for CfDs to deliver the full value envisaged in their development, we consider the following to be critical:

1. **Move to a fully competitive allocation process as soon as possible.** Which? believes that the current process of allocation into three pots - one for established technologies, another for emerging technologies and a final pot for biomass conversion - could distort competition in the market. There is no clear justification for the approach and budget

<sup>2</sup> The Imbalance of Power - Wholesale Costs and Retail Prices, Which?, July 2013; Which? response to Energy Market Investigation - Annotated Issues Statement, August 2014.

<sup>3</sup> Paragraph 38, Energy Market Investigation - Updated Issues Statement, CMA, February 2015

<sup>4</sup> Energy Market Investigation - Liquidity, CMA, March 2015

<sup>5</sup> The Imbalance of Power - The Challenge of Decarbonisation, Which?, July 2013



allocated to each pot. Which? proposes an alternative method of allocating Contracts for Difference that supports competition both within and between technologies (see annex 1).

2. **There must be confidence in the wholesale reference prices.** As set out above, we still have a number of concerns about the quality of price data which do not appear to have been explored.
3. **The Supplier Obligation must be an obligation on suppliers to pay back to consumers.** The central tenant of the CfD is that, should the market reference price be higher than the strike price, generators via suppliers will pay back to consumers unneeded subsidy support. In theory, this should occur via the Supplier Obligation. However, the Supplier Obligation currently relies on competition in the retail market to ensure that suppliers do in fact pay back to consumers. Given that the retail market is currently subject to investigation, this mechanism is clearly not adequate.

Which? is also in agreement with the CMA's assertion that awarding contracts through the Final Investment Decision enabling process, rather than through a competitive process, may not have delivered the best value for consumers.<sup>6</sup> Which? has called for a review of the contracts awarded through this process and how much more generation could have been commissioned for the money spent. All future contracts should be delivered through an open and competitive process.

### **Electricity Market Reform - Capacity Market**

Which? agrees with the findings of the CMA, that more effective competition could be introduced within in the Capacity Market. Which? also questions whether penalties for non-delivery are effective deterrents, as total penalties a capacity provider faces for non-delivery over the course of a year cannot rise above the revenue it receives from Capacity Market payments.

There is also a risk that the Capacity Market and cash-out payments could artificially inflate prices and lead to an over-subsidy for capacity paid for by consumers. This is unacceptable and we would urge the CMA to take action to address this issue.

### **Theory of Harm 3: Vertical Integration**

The CMA's analysis has explored a number of questions related to vertical integration, such as foreclosure. The CMA has asserted that the EMR and changes to the cash-out regime have and will continue to change the incentives around vertical integration of supply and generation.

However, given the prevalence of vertically integrated firms in the GB market, it is important that the incentives and actions of these firms are considered in the round as part of the CMA's investigation. We believe that there are a number of outstanding concerns in relation to vertical integration that do not appear to have been addressed in the analysis to date.

### **The role and impact of vertically integrated trading businesses**

Along with supply and generation, the vertically integrated firms have trading functions. We note that in the Generation Profitability working paper, two of the large vertically integrated firms were unable to report their generation profits because they couldn't clearly account

<sup>6</sup> Paragraph 60, Energy Market Investigation - Updated Issues Statement, CMA, February 2015



across the different business arms. Furthermore, the remaining firms had to use a series of assumptions in order to assign profits.

This raises serious questions about transparency within these firms, and the role and influence do trading arms play in determining the prices that supply businesses pay and the impact this has on consumer outcomes.

Finally, in the next stage of its analysis we believe that the CMA should extend this analysis to the early to mid-2000s - in particular the period between 2005 -2007 when suggests that retail businesses were loss making.

### **Managing margins**

Related to the above point, and the other business arms, there is little information on the ability of these firms to manage margins across the wider business; or the impact of this on consumer outcomes and prices.

We expect that these questions will be addressed in the preliminary findings report.

### **Theory of Harm 4: 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**

In this section, we provide comments on the CMA's analysis and proposed next steps, specifically on 1) Engagement and consumer outcomes; 2) Standard tariffs; and 3) the Retail Market Review. We also provide a summary of a piece of research looking at the outcomes for consumers in Scotland.

Finally, we set out an overview of our recent behavioural research into Simple Pricing and a summary of our proposals for the introduction of a Price to Beat. We believe a combination of these proposals will be critical to the development of market arrangements that work for consumers. To complement the summaries set out below, further detail is provided on these in annexes 2 and 3.

### **Engagement and consumer outcomes**

The Updated Issues Statement highlights the issue of low switching levels. The CMA raises questions about the extent to which regulatory interventions such as the prohibition of undue discrimination and the tariff cap required by the Retail Market Review (RMR) reforms, may have resulted in this.

### **Quality of switching decisions is the key metric**

Looking at switching levels, and what affects on these, is clearly important. In its analysis of switching, it is critical that the CMA also considers the more important metric of the quality of switching decisions - i.e. whether consumers are getting the right outcomes from their engagement with the market. A key measure should be the proportion of consumers on the cheapest deals. Price is consistently the primary motivation for switching,<sup>7</sup> therefore this represents a more useful and meaningful measure of successful switching outcomes.

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<sup>7</sup> 73% of respondents switched did so in order to get a cheaper deal/ save money, or because their supplier announced a price increase. Which? Energy Tracker, March 2015



Simply recording an increase in switching levels does not equate to evidence that competition in the energy market is working for consumers. As we saw with doorstep sales, although a greater number of people were engaging in the market, nearly one in two consumers were mis-sold tariffs.<sup>8</sup> This is clearly an unacceptable outcome, and an indication that the market is failing to respond positively to consumer behaviour.

Which? would therefore be concerned if analysis and proposed remedies were to focus on increasing switching numbers rather than good customer outcomes. We agree that it is important that the CMA considers the impact of regulatory intervention, such as the RMR's prohibition of cashback deals or the tariff cap. However we would not want to see the reintroduction of switching 'incentives' that drive consumers to engage but result in poor quality decision making. The ambition must be for greater engagement together with improved decision making and outcomes.

#### The impact of the cessation of doorstep sales on switching levels

A number of factors have been raised as possible causes for reduced switching rates. One that we consider to be important, and that is not mentioned in the Updated Issues Statement, is the cessation of door-step sales. Direct sales were used successfully by suppliers to drive switching particularly among vulnerable and elderly consumers.<sup>9</sup> However, as we set out above, the outcomes for the majority of consumers were poor and these higher rates of switching were not an indicator of a more competitive market.

#### Barriers to switching and engagement

The Updated Issues Statement sets out that the CMA will be doing further analysis to understand what the barriers to engagement really are. Which? believes that barriers to switching and engagement include complex pricing, poor customer service and low levels of confidence and trust in the sector. Further information on these is provided in annex 2.

#### *Customer service*

In the Updated Issues Statement, the CMA raises the possibility that some customers may place sufficient weight on the quality of service they receive and that the value of this service to the consumer outweighs the financial gains they may make from switching.<sup>10</sup> While this may be the case for some consumers, we believe that this will only apply in a small number of cases, for example where the supplier markets themselves as being a green or ethical provider. We know that price is the primary switching trigger.<sup>11</sup>

The suppliers with the highest retention rates (ie those with the greatest proportion of sticky customers) are also the largest suppliers who have:

- the lowest customer satisfaction ratings
- had sanctions against them in the last year, and
- have higher levels of complaints<sup>12</sup>

This suggests that there are other factors at play, a number of which we set out above.

<sup>8</sup> Energy Supply Probe - proposed market remedies, Ofgem, April 2009

<sup>9</sup> Energy Supply Probe - proposed market remedies, Ofgem, April 2009

<sup>10</sup> Paragraph 135, Energy Market Investigation - Updated Issues Statement, CMA, February 2015

<sup>11</sup> 73% of respondents switched did so in order to get a cheaper deal/ save money, or because their supplier announced a price increase. Which? Energy Tracker, March 2015

<sup>12</sup> Per 100,000 customers



### Gains from switching

The 'Gains from switching' working paper sets out that there will further analysis of the gains from switching, specifically the distribution of potential savings across different consumption levels.<sup>13</sup> Under the current tariff structure, not only can the gains vary by consumption type but the best tariff for one consumption level is not necessarily the best tariff for another consumption level. The introduction of Simple Pricing (see Remedies and annex 3) would address this issue. We recommend that the CMA include Simple Pricing as part of this analysis.

### **Standard tariffs**

Despite their higher cost, the vast majority of households are on a standard tariff from one of the large suppliers. Given that the cost of energy has consistently been a top financial concern for consumers, this is clear evidence that the current market arrangements are not working.

The Updated Issues Statement also confirms that these tariffs are more profitable for the large suppliers;<sup>14</sup> that there is evidence to suggest that the large suppliers have unilateral market power over the customers on these tariffs;<sup>15</sup> and that there are some of the right conditions for coordinated pricing activity in relation to these tariffs.<sup>16</sup> We recognise that having market power does not necessarily mean that a supplier is making excess profits. It can simply mean that the incentives to be more efficient are weaker.

The fact that many of these customers have been with their supplier for over 10 years and can generally be described as disengaged, highlights the need for a rethink in the type of market arrangements necessary to facilitate effective competition. Given the essential nature of energy, it is important that even those who do not engage pay a fair price for their energy, an outcome that is clearly not happening at the moment. This is discussed in more detail in the Remedies section below.

We note that the CMA has yet to take a view on the arguments that the large suppliers are keeping these customers disengaged in order to retain them on more expensive tariffs.<sup>17</sup> Clearly, any such activity has serious implications for the effectiveness of competition and consumer outcomes. We look forward to the analysis and the CMA's conclusions.

We also look forward to seeing the analysis of supplier claims that costs are higher to serve customers on standard variable tariffs, and the impact this has on prices that these consumers are paying.

### Weak competition on standard variable tariffs

Which? agrees with the CMA's conclusion that there is weaker competition on standard variable tariffs. We consider the energy retail market to be broadly split into two segments - the standard tariffs and the fixed term tariffs, with price based competition focussing on the fixed offers.

<sup>13</sup> Energy Market Investigation - Analysis of the gains from switching, CMA, February 2015

<sup>14</sup> Paragraph 122, Energy Market Investigation - Updated Issues Statement, CMA, February 2015

<sup>15</sup> Paragraph 144, Energy Market Investigation - Updated Issues Statement, CMA, February 2015

<sup>16</sup> Paragraph 151, Energy Market Investigation - Updated Issues Statement, CMA, February 2015

<sup>17</sup> Paragraph 145, Energy Market Investigation - Updated Issues Statement, CMA, February 2015



In the Updated Issues Statement, the CMA set out that there has been a weakening of competition on these tariffs and raises the question of whether the introduction of the undue discrimination clause had contributed to this.<sup>18</sup> We believe there are three further points to consider.

First, there is no evidence to suggest that standard tariffs were ever competitive or priced efficiently.

Second, the focus on fixed tariff offers rather than standard tariffs from 2009 onwards also coincided with the end of door-step sales. This was a major route to market for standard tariffs, as were telesales and direct sales in supermarkets.

Finally, the increased focus on fixed offers from 2009 also coincided with the advent of highly competitive offers from small suppliers.<sup>19</sup> Since then the small suppliers have primarily been the source of the most competitively priced offers.

### **Cost pass through and profitability**

#### Cost pass through and 'Rockets and Feathers'

In its analysis of cost pass through, the CMA noted that appears to be a widening gap between the costs and the level of standard variable prices, and that there appears to be a lag in the time it takes for standard tariffs to reflect cost decreases. This fits with our analysis looking at the relationship between wholesale costs and standard tariffs prices (see annex 4).

The analysis used hedging strategies that are representative for GB suppliers purchasing energy for standard tariffs. In summary our analysis suggested that:

- There was no rationale, in terms of wholesale movements, to justify the increases to gas and electricity prices in late 2013
- There has been room for the major suppliers to reduce electricity prices, based on hedged wholesale costs, and
- The recently announced reductions in standard gas tariff rates (of up to 5.1%) should be higher if they were to align with the wholesale market.

We recommend that in the next phase of their analysis, the CMA undertake similar analysis looking at all costs, across the full range of tariff types, as well as a longer time frame.

### Profitability

We welcome the CMA's proposal to undertake further analysis looking at the profitability of both different tariffs types and supply businesses as a whole.<sup>20</sup>

### **The Retail Market Review**

The Retail Market Review (RMR) and the Energy Supply Probe, which went before it, made a number of changes to the retail market. It is important that the CMA consider the impact of the RMR. Broadly, Which? agreed with much of the analysis undertaken in the RMR and the issues it highlighted. While a number of the reforms were positive, for example underpinning the Standards of Conduct in the Standard Licence Conditions, we did not support the

<sup>18</sup> Paragraph 158, Energy Market Investigation - Updated Issues Statement, CMA, February 2015

<sup>19</sup> The Imbalance of Power - The Retail Market, Which?, December 2012

<sup>20</sup> Paragraph 148, Energy Market Investigation - Updated Issues Statement, CMA, February 2015



introduction of the Tariff Comparison Rate, and we called for further simplification of the tariff structure (see Remedies and annex 3).

In addition to the points raised above, in assessing the impact of and reflecting the objectives of the RMR, we believe it is critical that the CMA consider:

- An increase in consumers' confidence to and in getting the best deal
- Greater awareness of savings that can be made, as a result of the new information remedies
- Increased proactive engagement at the end of fixed term contracts ie the extent to which consumers switch onto another fixed tariff rather than defaulting onto the standard tariff. It would be particularly interesting to understand the trends going back 5-10 years, and
- Increased consumer trust.

While there may be arguments from suppliers that regulation is restricting choice and resulting in poorer consumer outcomes, historically this market has had lots of choice which did not equate to good consumer outcomes.

#### **Additional issues for consideration - Consumer outcomes in Scotland**

Which? recently commissioned a report from Cornwall Energy looking at the market dynamics in Scotland and the outcomes for consumers in Scotland.<sup>21</sup> The analysis revealed a number of issues that affected consumers in both the North and South regions, as well as issues specific to each of these regions.

##### Cross-Scotland issues

- Across Scotland there is an above average proportion of household electricity consumers with the regional incumbent. In North Scotland, 66% of electricity consumers are supplied by SSE, the highest retained share in Great Britain. There is also a slightly higher than average proportion of consumers with Scottish Power in South Scotland at 42% compared with the GB average of 39%
- Independent suppliers typically hold lower market shares in the Scottish regions than elsewhere in GB, and
- Although exact regional figures are not available, switching levels in Scotland appear to be generally lower than the GB average.

##### North Scotland region:

- Household electricity market concentration as measured by the Herfindahl-Hirschman Index<sup>22</sup> in North Scotland is the highest in Great Britain. While the region has the highest electricity incumbent market share, consumers' access to gas may also be a factor influencing high concentration.
- North Scotland has the fewest household energy customers of any region in Great Britain. The number of electricity and gas accounts is equivalent to 35% and 23% of the respective GB average. Moreover only 55% of electricity customers in North Scotland can access mains gas (0.38mn), much lower than the next lowest region (South West England) where 72% of customers have access to gas. This raises question about the commercial appeal of these single fuel customers to suppliers versus prospective dual fuel customers.
- There are a small number of suppliers (three in February 2015) that do not actively offer tariffs in North Scotland meaning that customers have less choice of providers and tariffs.

<sup>21</sup> A copy of this paper is available on request.

<sup>22</sup> The Herfindahl-Hirschman Index (HHI) is a measure of market concentration.



### South Scotland region:

- South Scotland has lower electricity bills and network charges than the North Scotland and 13% lower than the rest of GB. This translates into variable dual fuel tariffs in South Scotland being among the cheapest in GB. However, compared with the rest of GB a number of other regions have access to cheaper fixed deals. In February 2015, South Scotland's cheapest tariff was ranked the fifth cheapest across the GB market.
- In South Scotland a higher proportion of energy customers pay with prepayment - 20.2% compared to the GB average of 17.1%. This proportion is also increasing more rapidly than the GB average.

It is also worth noting that on average the gas incumbent British Gas (and Scottish Gas in Scotland) has a market share of 40% across GB regions. Scottish Gas<sup>23</sup> share in the South Scotland region is in line with this at 40%; where as in the North Scotland region Scottish Gas market share is significantly lower at 32%.

It is likely that a number of issues that affect the North Scotland region in particular are issues that affect rural populations more broadly. It is important that the CMA in its investigation does consider the dynamics and consumer outcomes within each of the regional markets, as well as what the necessary reforms are at both a regional and national level.

### Remedies - Simple pricing and a Price to Beat

There is no single remedy that will improve competition in the retail market. A package of reforms will be required to address the multiple challenges and barriers to engagement and consumer outcomes that continue to exist. As previously mentioned, and discussed further in annex 2, complex and unfair pricing represents a key barrier to effective engagement and good consumer outcomes: Which? believes it is important that remedies tackle this ongoing challenge. The development of these remedies must reflect a realistic expectation of consumer engagement.

We believe that this should centre on market arrangements that deliver a better balance between consumer protection and competition. To date the focus has been too much on competition at the expense of ensuring fair outcomes for all consumers. Two key elements to this are the introduction of Simple Pricing and a Price to Beat.

### **Simple Pricing**

Which? believes that Simple Pricing - where gas and electricity prices are shown as a single rate per kWh - would offer much greater clarity. People would be able to compare prices much more easily, leading to better quality switching decisions and ultimately establishing the foundation for an effective competitive market.

Which? and EDF Energy have conducted new jointly commissioned behavioural research to understand the impact of energy pricing on consumer behaviour. The purpose was to identify whether a simpler pricing structure (like a petrol pump display), can encourage engagement and, crucially, lead to better switching outcomes for consumers. Annex 3 provides more detail on the design of the experiment and research findings. In summary:

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<sup>23</sup> British Gas/ Centrica



### Simple Pricing improves switching choices

Simple Pricing more than doubles the number of consumers choosing the cheapest tariff:

- Simple pricing more than doubles the number of respondents able to pick the cheapest tariff compared with doing the same task using the status quo of a standing charge and a unit rate. This was true for both price comparison websites (PCWs) (91% vs. 43%) and a price table choices (87% vs. 35%), like a newspaper ad.
- A key reason for these improved outcomes is that consumers do not need to know their consumption before choosing the cheapest tariff for them; ultimately, the cheapest unit rate for your payment type will be the cheapest tariff for you.

It is quicker and easier to make a choice:

- We recorded the time taken to complete each choice: a longer decision implies more effort was required. The average time people took to choose a tariff under the simpler pricing structure in a flat table was 36 seconds, compared to 55 seconds for those choosing under the current pricing format.
- Respondents also find it easier to identify the cheapest deal with Simple Pricing in a flat table: 61% said it was easy to make a choice with Simple Pricing against 38% who said making a choice was easy under the status quo.

Simple Pricing increases the likelihood to switch:

- Simple pricing also increases the proportion of respondents who intend to switch. On the price table task, 47% said they would switch when looking at the Simple Pricing table, compared to 38% who saw the price table with prices structured in standing charge plus unit rate format.

### Simple Pricing does not harm the potential of discounts to encourage consumer engagement

- The introduction of discounts across all tariff structures impacted on consumers' ability to identify the cheapest tariff.
- The most effective combination of discount and tariff structure in terms of enabling consumers to identify the cheapest tariff is Simple Pricing with a unit rate discount. Consumers also rated this option as the easiest discount to identify the cheapest tariff.
- While discounts with Simple Pricing reduce the ability of respondents to identify the cheapest tariff, discounts with Simple Pricing do not reduce respondents' intention to switch.
- Introducing discounts into the experiment increased the time needed for consumers to compare prices using a price table format by 22 seconds.

This research demonstrates that not only do consumers find Simple Pricing easier to understand; it also improves their ability to best deal and increases their reported intention to switch. The inclusion of discounts makes it more difficult for consumers to identify the best deal, but the impact of this can be limited when discounts are used in combination with Simple Pricing. We believe that the introduction of Simple Pricing is fundamental to improving the retail market.

### **Price to Beat**

The underlying principle behind the Price to Beat idea is that market arrangements will deliver better outcomes for all consumers, whether or not they decide to engage proactively.



A Price to Beat provides greater protection for consumers by offering reassurance around price, which is consistently the top consumer worry.<sup>24</sup> Establishing a fair price - or at the very least an indication of what fair is in this context - will deliver greater transparency and help consumers understand what makes up the price they pay. Providing consumers with a clear reference point helps to demystify prices and the comparison process for consumers, which would give people greater confidence in their ability to identify the best deal for them. If implemented it would also, crucially, provide some protection to the stickiest customers who do not switch.

It would also create a credible focal point for suppliers to compete around. Suppliers would be incentivised to compete against the Price to Beat and so it would become a key reference point for both consumers and suppliers. Price complexity and lack of transparency are major barriers to searching and switching, and therefore effective competition. But price is also the primary switching trigger and so should be seen by the CMA as a key factor when developing remedies to improve competition.

The paper *Price to Beat: achieving a balance between competition and consumer protection in the retail energy market* (annex 2) sets out further detail on the Price to Beat. This includes the different forms it could take, such as a reference price or a default tariff, as well as how the price could be set.

**Which? March 2015**

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<sup>24</sup> Which? Consumer Insight Tracker



## Annex 1: Which? Proposals for Competition in Contracts for Difference Allocation

Policies to promote investment in low carbon energy, paid for through bills, must deliver value for money for consumers. The Government estimates that by 2020 Contracts for Difference (CfD) subsidy costs alone will add around £30 to the average annual household electricity bill,<sup>1</sup> (and this is before the cost of paying for any exemptions for energy intensive companies and assuming average household consumption falls). Government data suggests EMR costs will be around £85 for the average household by 2030 (again before any exemptions),<sup>2</sup> having been even higher in the mid-2020s.

**We welcome the increased role for competition in subsidy allocation but the Government should go further still**

The Government's increased focus on a competitive process for CfD allocation is welcome<sup>3</sup> and is something we have argued for over the course of the past year. However, competition should not be seen as an end in itself. Its purpose here is to deliver the most 'bang for buck' from consumer subsidy. The Government should do more to ensure competition helps deliver this ultimate objective. Our concerns with the current direction of travel of the Government are as follows:

1. The Government has said that to help promote competitive allocation it will set the size of the budget available for the established, cheaper technologies, such that some projects will not get subsidy.<sup>4</sup> This will inevitably mean some cheaper projects will lose out to more expensive technologies in the 'less established pot' (or the less established pot and the Scottish Islands pot). Clearly this is not good news for consumers as it will not deliver best value for money from the subsidy spent.
2. The Government has said that there may be competition for contracts from day one for technologies in the 'less established technologies' grouping, but it has not yet committed to a competitive process.
3. Offshore wind is within the less established technologies group, even though deployment is already significant in GB. In 2013 there was around 3.5 GW of installed offshore wind capacity, with more in construction.<sup>5</sup> Offshore wind looks set to play an important role in the UK meeting its 2020 renewables target and in the UK's longer term plans for power sector decarbonisation. For example, even the National Grid's Slow Progression scenario would see 7.5 GW of total installed offshore wind capacity

<sup>1</sup> DECC, *Estimated Impacts of Energy and Climate Change Policies on Energy Prices and Bills*, March 2013

<sup>2</sup> Figures derived from DECC data in *Estimated Impacts of Energy and Climate Change Policies on Energy Prices and Bills*, March 2013

<sup>3</sup> For example a guarantee of competition for contracts from day one for technologies in the established technologies grouping.

<sup>4</sup> DECC *Electricity Market Reform: Allocation of Contracts for Difference. Government Response on Competitive Allocation*, May 2014: 6

<sup>5</sup> National Grid, *Electricity Ten Year Statement 2013*, Appendix F - Generation Data

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by 2020, and 15.9 GW of capacity by 2025.<sup>6</sup> Deployment on this scale means significant amounts of subsidy are at stake so it is crucial consumers get the best value for money from it. It is unclear how there will be any price competition for offshore wind under the current arrangements, unless it is the marginal technology within the less-established technologies group. In our view it is not appropriate to shield offshore wind developers from competitive cost pressure. We see no compelling reason why offshore wind developers should not at least compete with other offshore wind developers for subsidy to help drive down support costs. There are a wide range of costs across offshore wind projects but accurate cost information is hard to come by. Allocating subsidy competitively is the best way of revealing this information.

4. The Government has not set out a timeframe or means by which competition will be extended to other low carbon technologies to drive cost reductions and value for money.

### **A two-stage allocation process to drive price competition both within and between technologies**

In our response to the Government's most recent consultations on CfD allocation in December 2013 and February 2014 we set out a two-stage allocation process for how competition could work, which we developed with the energy consultancy Baringa. We continue to believe this model - which seeks to drive price competition both within and between technologies - is worthy of serious consideration and has advantages over the Government's approach. It is also compatible with increasing competition over time. The detail of our proposed approach is set out below.

#### **Stage I: Technology specific auctions (or an 'established technologies pot' and technology specific auctions).**

Under this approach, the available annual CfD Budget would be divided into an amount to be allocated on a technology specific basis, and an amount to be allocated on a generic basis, i.e. where different technologies compete for contracts (similar to the government's latest proposals for biomass conversion plants and Scottish islands onshore wind projects). The technology specific amount would be sub-divided by technology according to a modest, minimum volume requirement for each technology for the delivery year or years in question.

For all but the least mature technologies, i.e. tidal and wave, auctions would take place from Year 1. This would include onshore wind, large-scale solar photo-voltaics, offshore wind, large-scale hydro, landfill gas, biomass and energy from waste.<sup>7</sup>

#### **Stage II: Secondary generic auctions**

The objective of the secondary generic auctions would be to allocate the remaining budget to the lowest cost projects that are available for the delivery year in question.

<sup>6</sup> The National Grid's more ambitious Gone Green scenario would see 12.1 GW of installed offshore wind capacity by 2020, with this rising to 28.6 GW in 2025. National Grid, *UK, Future Energy Scenarios: UK Gas and Electricity Transmission*, July 2013: 75

<sup>7</sup> Baringa, *Approaches for Allocating Contracts for Difference - Report for Which?*, December 2013; Policy Exchange, *Going, Going, Gone: The Role of Auctions and Competition in Renewable Electricity Support* December 2013



The generic secondary auctions would be run after the technology specific allocation process. These would be open to developers of technologies that have exceeded their respective budget pot and who had bids that were unsuccessful in the first stage of allocation.<sup>8</sup> Any budget left over from under-subscribed technology specific auctions would be re-allocated to the secondary auctions.

To mitigate the potential gaming risk that developers could try to achieve a higher clearing price in the secondary auctions than in their technology specific auction, our model advocates the transfer of bids<sup>9</sup> from the initial auctions into the generic auctions. The outcome of the secondary auction should therefore be pay-as-bid rather than pay-as-clear.<sup>10</sup> Paying-as-bid would reduce the risk that some technologies simply default to their administrative strike price, because the marginal project (i.e. the project that sets the price) in the auction is a higher-cost technology. For example, in the established technologies pot, it is likely that if solar sets the price that there will be no price pressure or competition on onshore wind developers who will get the administrative strike price for that technology.

The proportion of the CfD budget available for secondary auctions should be increased progressively over time, preferably annually, with the timeline for this clearly set out by the Government. Ultimately the goal is full competitive auctioning across all technologies, including nuclear and CCS projects, and those renewable technologies which are currently less mature.

A technology specific auction would also seem the most viable approach for competition for nuclear and CCS in the short term, given the varied structure of CfDs across technologies (e.g. the different contract lengths and reference prices). However, we want to see all forms of low carbon electricity competing for subsidy as soon as possible, and a clear plan is needed from the Government setting out how this will be introduced.

As already stated, alongside this a few of the least mature technologies, such as tidal, would initially be allocated on a first-come, first-served basis. These technologies currently have very high costs and correspondingly very high subsidy levels, paid for by consumers. Wave and tidal stream, for example, have an administrative strike price of £305/MWh throughout the period 2014/15-2018/19. This is around six times the current market price. Unless there are significant reductions in the cost of these technologies over the next decade, subsidy for new developments should not be paid for through consumer bills. Clear and realistic targets for cost reduction should be developed for these technologies now.

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<sup>8</sup> Potentially those parties who wish to appeal the outcome of the initial allocation process could also participate in the secondary auction.

<sup>9</sup> In the case of a descending clock auction this would be the last price before the project was withdrawn from the auction.

<sup>10</sup> This does not mitigate the risk completely since participants may be able to anticipate the potential clearing prices in its technology specific auction and the secondary auctions, and bid accordingly. However, given imperfect information the risk of missing out on CfD allocation may be too great to bid strategically in this way. Also, Government would ultimately have the option of not running a secondary auction if it felt that it was unlikely to achieve value for money for consumers by doing so.



## **The Government should commit to publish a review of the allocation process in Summer 2015**

Irrespective of the approach taken to allocation, we want the Government to commit to publishing a review in 2015 setting out whether allocation has delivered value for money. A clear set of criteria for assessment should be developed now to inform this review. For example, the Government should publish data on the volume (in terms of MWs) worth of projects within the cheaper, established technology pot that missed out on a CfD to those technologies in more the less established/more expensive technology pot(s). This review should set out how much more investment in low carbon electricity could have been delivered with the same subsidy, had it gone to cheaper technologies. This analysis will be important for helping determine whether the auction design is delivering value for money for consumers and for identifying reforms. We recognise there will be limits to how much detail can be published on individual bids however we see no reason why information of this kind cannot be aggregated. Alongside this review the Government should commit to publish key auction data annually, for example on the number and spread of bids for each technology.

**Which? March 2015 (first published in 2013)**



## Annex 2: Price to Beat: achieving a balance between competition and consumer protection in the retail energy market

### 1. Introduction

Energy is an essential utility - people have no choice but to buy it. However this does not necessarily equate to engagement and a vibrant, competitive market. The current arrangements in Great Britain's energy retail market fail to deliver good consumer outcomes and effective competition. This is evident from relatively low switching rates, the significant proportion of consumers on more expensive standard tariffs, high numbers of complaints to energy suppliers and the ombudsman, as well as low levels of consumer trust and confidence. These issues are discussed in more detail in section 2 below.

Which? has welcomed the Competition and Markets Authority (CMA) inquiry into the energy market. It offers a real opportunity to improve consumer outcomes. Which? believes that achieving a better balance between an effective competitive market and consumer protection is key to driving these improvements. As part of the investigation, we have called on the CMA to explore a Price to Beat to give consumers greater confidence in the price they pay, to help increase trust and engagement in the sector - and so give competition a better chance to work.

Similar approaches are used in a number of energy markets, such as in Northern Ireland (NI) and Illinois (discussed in section 3 below). Research by Cornwall Energy found that in NI over 64% of consumers were happy with the price they pay for energy, and 74% trust their supplier<sup>1</sup> - a staggering contrast to the 19%<sup>2</sup> who trust their supplier to deliver a fair price and overall trust in the energy sector is at just 24% in GB.<sup>3</sup> Furthermore, 63% of GB consumers said they would support a regulated tariff akin to that found in Illinois.<sup>4</sup> Over 160,000 people have also now signed up to our petition on fair energy prices - calling for the introduction of Price to Beat and Simple Pricing.<sup>5</sup>

Which? believes that consumers need a credible, independent benchmark against which to compare prices. We think there is value in creating a fair and efficient focal point to anchor consumer decisions and drive competition. Section 3 outlines a range of options for a Price to Beat and how it could work. Box 1 below outlines the options that we have explored.

<sup>1</sup> Cornwall Energy, Review of the effectiveness of competition in the Northern Ireland energy retail market, November 2014, p.36.

<sup>2</sup> Which? Energy Tracker, March 2015.

<sup>3</sup> Which? Consumer Insight Tracker, February 2015.

<sup>4</sup> Which? research, September 2014.

<sup>5</sup> <http://www.which.co.uk/campaigns/fair-energy-prices/>.

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**Box 1 - Options for a Price to Beat**

1. Regulated default tariff provided by a regulator-approved agency
2. Regulation of the major suppliers' standard variable tariffs
3. A reference price/series of reference prices set and published by the regulator
4. Provision of better defaults
5. Regulated default tariff for vulnerable consumers

This paper sets out the key problems for consumers, which are entrenched within the current retail market arrangements. The key indicators discussed below are well-known, and clearly illustrate the consumer detriment that is occurring as a result of ineffective competition and arrangements that are not designed around real consumer behaviour and decisions. This paper then sets out the importance of achieving a balance between effective competition and robust consumer protection.

**1.1 The reality of consumer engagement in the retail market**

The introduction of a Price to Beat would encourage the market to positively respond to real consumer behaviour. It is increasingly accepted that human behaviour does not follow the rational assumptions that economic textbooks make. An economic textbook 'consumer' has known and consistent preferences, is aware of and can compute all the necessary information to make consumption decisions. They are primarily motivated by self-interest. They weigh up their decisions carefully and have a rational reason for doing something. However, behavioural science has shown that real consumers deviate from these assumptions in predictable and persistent ways, and most decision-making uses thought processes that are intuitive and automatic rather than deliberative and controlled.

Consumers are expected to place the same value on finding a good deal in a market that is very complex or uninteresting with finding one in an area which is more interesting or simpler to understand. For example, in the energy retail market, despite the availability of significantly cheaper tariffs and the ability to switch away from suppliers with poor customer service, the vast majority of consumers do not. As a result, the majority of consumers remain on expensive standard tariffs and the incumbent suppliers still benefit from large sticky customer bases. In other words, consumers are not exercising competitive restraint on the market even though better outcomes are available. This is key to driving an effective competitive market.

## 2. Consumer outcomes and barriers to engagement

### 2.1 The majority of consumers remain on expensive standard tariffs

The majority of households - an estimated 75%<sup>6</sup> - are on the more expensive standard variable tariffs from one of the six major energy suppliers, who between them supply approximately 90% of households.<sup>7</sup> The CMA's analysis found that major suppliers are also making on average 12% and 13% more per kWh on their electricity and gas standard tariffs respectively, compared to average revenue from non-standard tariffs.<sup>8</sup> This is a key indicator that competition in the energy market is failing consumers: that so many households are on tariffs for which suppliers appear to be able to charge more shows that the market is not constraining the prices of these offers. This is in addition to the fact that energy prices are of high concern to consumers and cheaper deals are available that households are not switching to. Furthermore, this consumer stickiness and supplier ability to charge more appears to continue despite regulatory intervention as part of RMR to force suppliers to tell their customers via regular communications<sup>9</sup> if they could be on a cheaper tariff.

Table 1 below displays the difference between the major suppliers' standard tariffs (paper bills) and their cheapest offer, as an average across GB. This is based on Ofgem's medium usage figures<sup>10</sup>, dual fuel and direct debit payment type. As can be seen from the table, customers on a standard dual fuel tariff with Scottish Power, Npower or EDF would save a significant proportion of the bill by switching to the cheapest tariff. And there are still savings to be made by switching away from the standard across all the large suppliers, amounting to an average saving of £133.10.

**Table 1: Difference between dual fuel standard variable tariff (SVT) and cheapest tariff by supplier (tariffs on the market as at 25 March 2015)**

Energy supplier	Saving from dual fuel SVT to cheapest (based on medium usage) <sup>11</sup>
British Gas	£57.17
EDF	£190.34
E.ON	£44.05
Npower	£214.40
Scottish Power	£217.39
SSE	£75.24

<sup>6</sup> DECC, Quarterly domestic energy customer numbers, tables 2.4.2 and 2.5.2, December 2014.

<sup>7</sup> Cornwall Energy market share survey found that in the quarter to 31 October 2014, independent suppliers had gained a 10% share of the household dual fuel market. Domestic energy market shares: Cornwall Energy information note, 15 December 2014.

<sup>8</sup> Competition and Markets Authority, Updated Issues Statement, February 2015.

<sup>9</sup> Bills/statements of account, annual statement, price increase notification.

<sup>10</sup> Ofgem's Typical Domestic Consumption Values (TDCVs) are 13,500 kWh for a medium gas user and 3,200 for a medium electricity user.

<sup>11</sup> Energylinx data, 25 March 2015.



As well as being the most expensive offers, standard tariffs also make up the smallest segment in terms of tariff type on offer. As at 25 March 2015 there are 69 tariffs available to a customer paying by monthly direct debit, yet the majority of consumers are concentrated on six of these tariffs.<sup>12</sup> This means that the majority of consumers are spread across a minority of expensive tariffs, despite the availability of cheaper options. Therefore the size of the differential between the most expensive and cheapest tariffs should not be regarded as evidence in support of the existence of a truly competitive market. The availability of good value options is clearly important in driving competition, but this cannot be taken at face value. If consumers are not taking advantage of these savings despite being worried about the cost of energy, there is evidently a breakdown in consumer confidence and capacity to engage. It appears that suppliers are able to price discriminate on the basis of a lack of engagement, which they have no incentive to tackle. We address this challenge further in section 4.

An additional consideration to this sticky customer problem is that a significant proportion of consumers are still with their incumbent supplier on these more expensive tariffs. Around 40% of British Gas's household gas customers have been with this supplier for more than ten years, and for each of the electricity incumbent suppliers this is around 40% to 50%. For one electricity incumbent this proportion is as much as 60% to 70%.<sup>13</sup> This suggests that they have either never switched or may have just switched one fuel in order to have both gas and electricity supplied by the same company. As these consumers are inherently sticky, there is no incentive on the suppliers to improve the value of these tariffs. This 'incumbency effect' is also particularly concerning due to the disproportionate number of vulnerable consumers affected.<sup>14</sup>

Ofgem has recently made an additional submission to the CMA on the incumbency issue, stressing the importance of assessing the uneven distribution of inactive consumers in the energy market. The regulator believes that this concentration of sticky consumers with the incumbent suppliers is of particular concern, suggesting that it continues to have an adverse effect on customer outcomes and competition.<sup>15</sup>

## 2.2 Barriers to engagement continue to exist

There are a number of barriers to engagement such as complex pricing, poor customer service and lack of trust and confidence in the sector. Ofgem's Retail Market Review (RMR), carried out from 2010 to 2013, resulted in a package of reforms intended to address these major barriers. Key reforms include:

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<sup>12</sup> Tariff number based on Energylinx data 25 March 2015, of tariffs available to dual fuel, monthly direct debit, medium user. This data is based on an average of suppliers' prices across GB rather than a particular region.

<sup>13</sup> CMA, Updated Issues Statement.

<sup>14</sup> Ofgem, Submission to the CMA: Incumbency in the retail energy market, January 2015.

<sup>15</sup> Ibid.



- **Standards of Conduct (SoC)** - principles-based regulation that requires suppliers to treat their customers fairly in all interactions they have. These rules were the first of the RMR package to come into force in August 2013.<sup>16</sup>
- **Tariff cap** - all suppliers are limited to four core tariffs per fuel (and meter type).
- **Reforms to the way that tariff prices are structured** - all tariffs must be structured in a standing charge and unit rate format. Tiered pricing was also abolished.<sup>17</sup>
- **The introduction of new information remedies** - such as the Tariff Information Label (TIL) and Tariff Comparison Rate (TCR) to help people make comparisons. Suppliers must display certain pieces of tariff information in specified customer communications and on price comparison sites, as well as being more prescriptive over key communications such as bills, annual statements, price increase notifications and end of fixed term notices. There is also a requirement on suppliers to highlight on these communications where the customer could switch to a cheaper deal and how much they could save. These information requirements were mandatory as of March 31 2014.<sup>18</sup>

While Which? supported a number of the changes, we do not believe that the RMR went far enough in making the market work better for consumers and as is now clear, barriers still exist.

### ***Complex pricing***

Comparing deals has been notoriously difficult and gains as a result of switching are uncertain. Where consumers are faced with complex, time-consuming decisions they tend to defer such decisions and display status quo bias. While steps have been taken by Ofgem to simplify the market and improve the comparison process through the RMR, this has not gone far enough. It is still a minefield for consumers and it is impossible to make at-a-glance comparisons of tariffs as they are currently structured. Furthermore, consumers are not able to establish whether the price they are paying is fair or offers value for money. There is no independent benchmark or indication of what is fair or reasonable.

Which? has put forward a number of proposals to address this and has called for simple pricing in the form of a single unit rate so that consumers can easily spot which tariff will be the cheapest for them. This is discussed in Box 2 below. Which? has also called for the CMA to consider ways to implement a Price to Beat - providing a fair default tariff or benchmark price to provide additional consumer protection, while also driving competition. We explore the options for a Price to Beat section 3 in below.

<sup>16</sup> RMR, Implementation of the domestic Standards of Conduct - decision to make licence modifications, June 2013.

<sup>17</sup> RMR, Implementation of Simpler Tariff Choices and Clearer Information, August 2013.

<sup>18</sup> Ibid.

## Box 2 - Simple pricing

Which? has long campaigned for the introduction of simple pricing. The standing charge element of tariff prices should be abolished so that all tariffs are structured simply as a single unit price. This helps consumers to make comparisons at a glance and to more easily identify the best deal for them. With simple pricing, people do not need to know their usage in order to spot the best deal - the cheapest tariff will be the cheapest for everyone.

Which?, in collaboration with EDF Energy, recently built on its research in this area. We carried out behavioural testing with consumers in order to observe consumer decisions when faced with the task of identifying the cheapest tariff for them across a range of pricing structures, including simple pricing and the status quo.<sup>19</sup> Consumers were asked to carry out this task from a best buy table format as well as in a price comparison website (PCW) scenario. This research found that simple pricing more than doubles the number of consumers able to pick the cheapest tariff compared to the status quo, for both the table format and PCW scenario. The research also found that making decisions based on simple pricing takes less time and effort, and in some cases increases the intention to switch. See annex X of our response to the CMA's Updated Issues Statement for a full breakdown of the research.

Simple pricing also has the support of a number of energy suppliers including EDF Energy, as well as Utilita and Ebico who already have it in place. These suppliers agree that it is a clearer approach that will benefit competition and consumers.

Simple pricing would work in conjunction with a Price to Beat, making the market easier for consumers to navigate, increasing consumer confidence in identifying the best deals and improving trust and understanding in suppliers' tariff prices.

## Poor customer service and complaints

In a truly competitive market we would expect to see improvements in suppliers' customer service driven by fear of losing customers to rivals and to help attract new business. Over the last year complaints to the six major suppliers have risen by 19%<sup>20</sup> and complaints received by the Energy Ombudsman more than doubled between 2013 and 2014, yet there has been no significant, long-term switching response. This is despite the widespread experience and reporting of poor complaints handling and the subsequent failures in quick, effective resolution.<sup>21</sup> Two of the major suppliers - Npower and Scottish Power - are in fact under investigation by the regulator with specific targets to meet in order to put these mistakes right.<sup>22</sup> It is evident from this kind of regulatory intervention that competition is failing to

<sup>19</sup> Status quo refers to the current mandatory pricing structure for all tariffs of a daily standing charge plus unit rate.

<sup>20</sup> Ofgem complaints data 2014.

<sup>21</sup> This includes making customers wait an unacceptable amount of time when resolving problems with inaccurate and late bills and unacceptable call waiting times.

<sup>22</sup> Npower is currently under investigation under the new Standards of Conduct (SoC), the first of the reforms implemented by RMR, which introduced a new licence condition requiring suppliers to treat their customers fairly. As part of this investigation Ofgem set targets for Npower to meet in relation to late invoices, backbilling and complaints numbers. Similarly, an ongoing investigation into Scottish Power's compliance with the SoC has set targets and deadlines for prompt response to customer queries, late billing and outstanding ombudsman remedies.



deliver the good customer service and outcomes that we would expect to see in a properly functioning market.

These problems are chronic across the sector and result in a sense that all suppliers are the same, which in turn creates a barrier to consumer engagement. Rather than driving people to switch to a new provider, many are simply discouraged from engaging with their supplier at all as the perceived hassle is too great and spending time searching for new deals does not feel like time well spent.

### ***Lack of consumer trust and confidence in the sector***

It is widely accepted that a fundamental lack of trust and confidence underpins the low levels of consumer engagement in the retail energy market. In the most recent Which? Consumer Insight tracker, trust in the energy sector is at just 18% (February 2015) which is the lowest level we have seen since energy price rises in Autumn 2013. Concern about prices remains high with two thirds of people (66%) saying they are worried.<sup>23</sup> As we set out above, this sits alongside a perception that all suppliers are the same and are profit driven to the detriment of consumers' best interests.<sup>24</sup> This drives a feeling of apathy and disengagement as consumers feel that there is little to be gained from engaging and switching. This in turn fails to incentivise suppliers to improve customer outcomes, which perpetuates the cycle of poor customer service, low trust and confidence. The ultimate outcome is weak competition and high prices.

Ofgem has recognised the problem of low trust and intends to measure this as part of the monitoring and evaluation of RMR.<sup>25</sup> There is also now an increasing recognition among energy suppliers - particularly following the introduction of the Standards of Conduct - that consumer trust and treating both new and existing customers fairly is an important aspect to driving a competitive energy market. While it is encouraging to see this recognition both from the regulator and industry, we are yet to see improvements in consumer attitude and outcomes, indicating that more needs to be done to build trust and confidence.

## **2.3 Ongoing barriers to engagement need to be addressed by striking a better balance between competition and consumer protection**

The way that the market is currently set up does not support real consumer behaviour and Which? sees the problems outlined above as major indicators of this. The RMR reforms fail to fundamentally change the way that consumers interact with the market and so on their own they are not enough to foster greater engagement and drive competition. The understanding of how consumers behave and make choices in reality is yet to be incorporated into the way the energy retail market functions. The Updated Issues Statement found that standard tariffs

<sup>23</sup> Consumer Insight Tracker, February 2015.

<sup>24</sup> Energy tracker, March 2015 - 45% of respondents said that they don't trust suppliers to act in their best interests because they are profit driven.

<sup>25</sup> Ofgem open letter: Domestic Retail Market Review - Evaluation framework and baseline results, July 2014.



are more profitable for the large suppliers,<sup>26</sup> that there is evidence to suggest that the large suppliers have unilateral market power over the customers on these tariffs,<sup>27</sup> and that the right conditions for coordinated pricing activity in relation to standard tariffs may exist highlight the need to make this market work better for consumers.<sup>28</sup>

Which? believes that this can be remedied by balancing competition with enhanced consumer protection, which will increase confidence to engage and drive effective competition. The focus of this additional protection should be on giving people greater confidence in, and understanding of, the price they pay.

### 3. Price to Beat

Which? has called on the CMA to explore the option of establishing a Price to Beat for the energy market in order to address a number of the issues faced by consumers discussed above. The underlying principle behind the Price to Beat idea is that market arrangements should deliver better outcomes for all consumers, whether or not they decide to engage proactively.

A Price to Beat provides greater protection for consumers by offering reassurance around price, which is consistently the top consumer worry.<sup>29</sup> Establishing a fair price - or at the very least an indication of what fair is in this context - will deliver greater transparency. Providing consumers with a clear reference point helps to demystify prices and the comparison process, which would give consumers greater confidence in their ability to identify the best deal for them. If implemented it would also, crucially, provide some protection to the stickiest customers who do not switch.

It would also create a credible focal point for supplier competition. Suppliers would be incentivised to compete against the Price to Beat and so it would become a key reference point for both consumers and suppliers. As discussed in section 2, price complexity and lack of transparency are major barriers to searching and switching, and therefore effective competition. But price is also the primary switching trigger - in the latest Which? Energy Tracker, 60% of respondents who had switched said they did so in order to get a cheaper deal/save money, 13% switched because of a price rise and 10% wanted a tariff with a fixed price.<sup>30</sup> Price should therefore be seen by the CMA as a key factor when developing remedies to improve competition.

<sup>26</sup> CMA, Updated Issues Statement, p. 27.

<sup>27</sup> CMA, Updated Issues Statement, p. 33.

<sup>28</sup> CMA, Updated Issues Statement, p. 34.

<sup>29</sup> Worry about energy prices is at 66% in the Which? Consumer Insight Tracker, February 2015.

<sup>30</sup> Which? Energy Tracker, March 2015.



### ***Setting the price***

A Price to Beat could be set either by Ofgem or an independent authority. We explore the option of an independent authority, with responsibility for price setting, further in box 3 below.

#### **Box 3 - Establishing an independent authority to set the Price to Beat**

The CMA should consider the establishment of an independent authority with the responsibility to set a fair price for gas and electricity. This would be a body similar to the Monetary Policy Committee (MPC) which is responsible for setting interest rates. This body could exist either to create a fair reference price or in setting the price of a regulated tariff. As with the MPC, it would consist of experts and be independent of the regulator and government, considering factors such as supplier operating costs, wholesale costs, the retail-wholesale link and the level of a fair retail profit margin.

In developing the proposals set out below, we have considered the role of defaults, reference prices and price anchoring in helping consumers make better choices and driving better outcomes.

Which? has also looked to other energy retail markets, including Northern Ireland (NI). We referred to the NI energy market when we first put forward the idea of a regulated backstop tariff in our report *The Imbalance of power: the retail market* (December 2012). More recently, the NI Utility Regulator commissioned Cornwall Energy to undertake a review of the effectiveness of competition in their market and Which? was interviewed as part of this process. Cornwall Energy's report refers to NI's form of price regulation in their hybrid market as a Price to Beat, stating that where there are high incumbent market shares '...price regulation acts as a proxy to competition'.<sup>31</sup> The review has argued that the competitive element of the NI market is driven by new entrants attempting to match or undercut the regulated tariff.<sup>32</sup> Which? envisages a Price to Beat in the GB energy market operating in this way, acting as a focal point for competition and providing extra protection for consumers by helping them make the best decisions for them. NI is not the only market we have drawn on. We have also considered the Illinois price setting process (box 5) and the recent deregulation of tariffs in Victoria, Australia (box 6).

### ***Options for a Price to Beat***

Which? has identified a number of options for implementing a Price to Beat, which vary in their level of intervention. Each option and the benefits it would bring in realigning the balance between competition and consumer protection, is outlined below. The potential challenges to a Price to Beat are addressed in section 4. It should be remembered that these proposals will not bring about an effective competitive energy market in and of themselves - but would act as a fundamental building block. For example, for a Price to Beat to operate at an optimal level it should be underpinned by competitive, liquid wholesale markets. Which?

<sup>31</sup> Cornwall Energy, Review of the effectiveness of competition in the Northern Ireland energy retail market, p. 39.



also wants to see the introduction of simple pricing (see box 2) working in conjunction with a Price to Beat to make comparisons more straightforward so that people can easily identify the best deal for them.

Which? believes that the CMA should carefully consider these options for a Price to Beat in the development of its remedies.

### **3.1 Option 1: Regulated default tariff provided by a regulator-approved agency**

A regulated tariff represents the most interventionist of the Price to Beat options. An agency approved by the regulator would supply a regulated, price controlled tariff. A price setting process would be carried out by the regulator or another independent authority (see box 3). The objective of this tariff would not be to guarantee the cheapest price, but to offer a fair, transparent price for all consumers.

Consumers on standard variable tariffs - around 75% of the market - would be transferred onto this tariff, with the option to opt-out should they wish to do so. In such situations, the customer could opt to move either to another supplier or onto another deal with their current supplier. In order to be most effective, the regulated tariff would also replace suppliers' standard variable tariffs as the default tariff at the end of fixed term contracts where the consumer has taken no action to switch to another deal. This would help to reset the energy market, eroding the very large sticky customer bases of the major suppliers.

The regulated tariff would be opt-in for consumers already on fixed deals, so they would have to make a decision to switch to it. The main benefit for these 'engaged' customers is to allow them to compare current and future deals against the regulated tariff - which would be a trusted, independent and fair benchmark price.

Competition would continue to exist across the rest of the market and we would expect to see suppliers competing with the regulated tariff on price in order to gain market share. It is interesting to note that in NI one of the competing suppliers, Budget Energy - who offer the lowest price - advertise themselves as 'Based on Power NI Standard Rate', clearly using the regulated electricity price as a reference point.<sup>33</sup>

Which? recognises that this would be a fundamental change to the current make-up of the market. However, the major suppliers still retain around 90% of the household market between them with a large proportion of sticky customers.<sup>34</sup> In order for a competitive market to exist the related issues of the dominance of the major suppliers and the high proportion of inactive customers must be tackled.

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<sup>32</sup> Ibid.

<sup>33</sup> <http://www.budgetenergy.co.uk/>

<sup>34</sup> Cornwall Energy market share survey found that in the quarter to 31 October 2014, independent suppliers had gained a 10% share of the household dual fuel market.

### ***International models***

Similar hybrid models already exist in the US State of Illinois and NI (see boxes 4 & 5). Although these models have been arrived at from a different starting point to the position that the GB retail market is in now, these models have benefits for consumers and competition. In its review of the effectiveness of competition in the NI energy retail market, Cornwall Energy has cited transparency as a beneficial feature of a market with price regulation.<sup>35</sup> The same report argues that the competitive part of the market has been driven by alternative suppliers seeking to undercut the regulated price. With regards to end prices, these have generally moved in line with the regulated incumbent and some competing suppliers sell their offers on the basis that they will always be at a certain level below the regulated tariff. The review concludes that price controls do not appear to have constrained competition but rather they have limited prices for customers who have not switched.<sup>36</sup>

In Illinois, the regulated tariffs of the utility companies ComEd and Ameren - which are non-profit making - are referred to as the 'price to compare', clearly suggesting that these prices are intended to act as reference points for consumers in order to compare different tariffs.<sup>37</sup> When Which? asked consumers if they would support or oppose a regulated tariff, as in the case of Illinois, 63% of respondents said they would (September 2014).<sup>38</sup>

These markets are able to offer real transparency around how the price is made up as they must be approved by the regulator. In NI, tariff rates are published on Power NI's website and each time there is a tariff review the Utility Regulator publishes a briefing paper explaining the new maximum average charge.<sup>39</sup> The end price is therefore open to scrutiny by consumers, government, suppliers and any other interested parties such as campaign groups and consumer bodies. In its *Strategic Approach Information Paper* (May 2014) the NI Utility Regulator maintains that their market displays how regulation and competition can 'usefully coexist' and that a hybrid market brings benefits in the form of restraint on excessive profits and price transparency for consumers, government and regulators.<sup>40</sup>

### ***Regulated prices do not necessarily mean inefficient prices***

It is particularly interesting to note that the most recent review of Power NI's prices was triggered due the forecasting of lower wholesale prices. Given the CMA's initial findings on cost pass-through which highlights where falling costs do not appear to have been reflected in prices, Which? believes that this mechanism is important. The price-setting process of a Price to Beat would apply a similar mechanism in order to ensure that decreasing costs are reflected in prices, not just increases. Which? welcomes the analysis already carried out in this area and will be following closely the additional work that the CMA intends to carry out

<sup>35</sup> Cornwall Energy, Review of the effectiveness of competition in the Northern Ireland energy retail market, p.7.

<sup>36</sup> Cornwall Energy, Review of the effectiveness of competition in the Northern Ireland energy retail market, p. 55.

<sup>37</sup> Citizen's Utility Board, The Illinois Electric Market, May 2014, p. 4.

<sup>38</sup> Which? research, September 2014.

<sup>39</sup> This is the maximum end price that the regulated supplier can charge.

<sup>40</sup> Cornwall Energy, Review of the effectiveness of competition in the Northern Ireland energy retail market, p. 55.



on asymmetric cost pass-through and the rate at which changes in costs are reflected in prices across different tariff types.

Moving customers off expensive standard tariffs would reset the market and give competition the chance to thrive effectively, encouraging companies to compete for customers and removing their ability to rely on sticky customers who do not switch. It would also help to restrict any ability to cross-subsidise their cheaper deals with customers on standard tariffs as it would be more difficult for suppliers to charge over the odds when they are competing with a fair Price to Beat. The Updated Issues Statement found that on average the major suppliers' standard tariff profit margins are around 12% higher than on their other, cheaper tariffs.<sup>41</sup> Which? welcomes the CMA's intention to investigate the claim made by some suppliers that the costs to serve standard tariff customers are higher than for those on fixed tariffs.

#### **Box 4 - Northern Ireland's hybrid retail market**

The energy market in NI operates as a hybrid market - the tariffs offered by the incumbent gas and electricity suppliers remain price controlled. For electricity, new entrants can enter and compete for customers without this price restraint. This is the case to some extent in the gas market and this will open up further in April this year.

Power NI is the former incumbent electricity supplier and has a 73% share of the domestic electricity market. The former incumbent gas supplier is SSE Airtricity in the Greater Belfast area, with 72% of household customers. In the Ten Towns area, Firmus is the incumbent and the only supplier available to domestic gas customers.

While these incumbents still have large market shares, new entrants are able to enter the market and compete for customers. Budget Energy entered the market in 2011 and now has around 60,000 customers which represents 5% of the market.<sup>42</sup> Budget Energy is the cheapest electricity provider and also received the highest customer score (61%) of the NI energy suppliers rated in the Which? Satisfaction Survey 2015.

#### **How the NI price controls work - Power NI's standard electricity tariff**

The Utility Regulator sets the 'maximum average charge' which is the maximum end price that the regulated suppliers can charge domestic and small business customers. In theory, the suppliers can charge below this rate but not above it. The tariff is made up of four elements: supplier operating costs, profits, wholesale costs and network costs.

It is the first two elements which are price controlled - the NI Utility Regulator dictates the cost that the supplier needs to recover from customers to run an efficient business and allows a level of profit. In projecting the wholesale costs, the Utility Regulator agrees with the company an estimate of what they will spend. The network costs are regulated separately, as

<sup>41</sup> CMA, Updated Issues Statement, p. 27. This is over the period of 2011 to Quarter 2 2014.

<sup>42</sup> <http://www.bbc.co.uk/news/uk-northern-ireland-31321383>

is the case in Great Britain.

The price control process takes place every three years, with the full regulated tariff calculation conducted annually. There is also a reconciliation mechanism in place to allow any under or over-forecasting to be recovered accordingly. The Utility Regulator looks at what the company actually earned compared to what it was projected to recover. If the supplier has recovered more than was projected, this will be taken into account in the next price setting process so that consumers are not paying more than they should. Indeed, the most recent review was triggered primarily as a result of a fall in forward gas prices, resulting in a lower forecast wholesale electricity price.<sup>43</sup> This sends a message both to consumers and the regulated companies that customers should not be taken advantage of and that end prices are expected to reflect falls in wholesale costs, not just increases.

#### **Power NI customer score**

Power NI scored 48% in the Which? satisfaction survey 2015. This was the lowest score of the four suppliers rated in NI (Power NI, Budget Energy, Firmus Energy and SSE Airtricity).<sup>44</sup> This is likely to be reflective of the lower prices offered by the other suppliers (Budget Energy scored 61%) and so suggests that alternative suppliers who can beat the regulated price and provide good customer service can compete in a hybrid market.

Cornwall Energy also carried out an omnibus survey in which 64% of respondents said they were happy with the price they pay for electricity, and 70% said the same for gas. This survey also found high levels of trust with 74% saying they trust or tend to trust their electricity supplier.<sup>45</sup>

#### **Box 5 - How the regulated prices are set in Illinois**

The Illinois Power Agency (IPA) is responsible for purchasing all electricity for both ComEd and Ameren. These are the non-profit making incumbent suppliers. Each year the IPA releases three Requests for Proposals (RFP) for electricity:

- 35% of the electricity that will be needed by both companies in 2 years
- 35% needed next year
- 30% needed this year

This means that the price of electricity currently supplied to consumers is made up of these different supply arrangements, in the same proportions as detailed above. This is the electricity supply charge. There is also a transmission service charge which is the equivalent of the regulated network charges in the UK.

The final component of the end price for consumers of ComEd and Ameren is the Purchased

<sup>43</sup> Northern Ireland Utility Regulator, Conclusion of the Utility Regulator's Review of the Power NI Ltd Maximum Average Price, February 2015.

<sup>44</sup> Which?, Best energy companies 2015, February 2015 issue.

<sup>45</sup> Cornwall Energy, Review of the effectiveness of competition in the Northern Ireland energy retail market , p.36.

Electricity Adjustment. The suppliers must be capable of responding to changes in demand. This is dealt with through a clearing house in which suppliers buy and sell power according to demand. The Purchased Electricity Adjustment reflects the savings when ComEd or Ameren sell electricity, and the extra cost when they have to buy more.

### 3.2 Option 2: Regulated standard tariff offered by the major suppliers

Rather than a regulated tariff supplied by an independent agency, an alternative option would be for each of the six major suppliers to offer a regulated standard variable tariff in place of their current standard tariff. Although this would not immediately address the issue of the large proportion of sticky and generally disengaged customers retained by the major suppliers, it would still provide some protection for these households by ensuring that they are paying a fair price. As the tariff would not require the setting up of a new independent supplier, it could be implemented at less expense. As with the option above, the price could be set by Ofgem, another regulator-approved agency or by an independent authority such as is outlined in box 3. It would then be mandatory for suppliers to apply this price to their standard tariff to prevent standard tariff customers paying over the odds.

The Updated Issues Statement (CMA, February 2015) confirmed that the revenues of the six major energy suppliers generated from their standard tariffs are 12% higher than for their non-standard (fixed term) tariffs for both gas and electricity.<sup>46</sup> The gap between the price of the average large supplier standard tariff and measures of direct costs<sup>47</sup> - including wholesale costs, network costs and policy costs - has been widening since 2009, suggesting that the price of standard tariffs is becoming less reflective of the most significant costs which feed into it.<sup>48</sup> The CMA believes that this suggests a weakening of competition on standard tariffs over time, making the case for greater protection of consumers on these tariffs.<sup>49</sup>

#### *International comparisons*

Box 6 discusses the recent deregulation of electricity prices in Victoria, Australia, and the findings that suppliers appear to be achieving greater profits since the removal of regulation. Consumers do not appear to be searching and switching to better deals. One proposal to try and improve customer outcomes focuses around reform of the 'standing offer' - a tariff that suppliers are required by legislation to provide - so that it operates as a more effective benchmark price (see box 6). This appears similar in nature to a Price to Beat and serves as an interesting comparison as there is clearly already a recognition that market arrangements are not delivering the best outcomes for consumers following recent deregulation.

<sup>46</sup> CMA, Updated Issues Statement, p. 27.

<sup>47</sup> CMA, Updated Issues Statement, Figure 1, p. 28. The average price of the major 6 energy suppliers' standard tariffs was tracked against Ofgem's Supply Market Indicator (SMI) and a one year cost benchmark calculated by the CMA.

<sup>48</sup> CMA, Updated Issues Statement, p.28.

<sup>49</sup> CMA, Updated Issues Statement, CMA, February 2015, p.29.

### *Impact on suppliers' businesses*

Which? accepts that this proposal may result in lower returns for suppliers on their standard tariffs. However, we believe that the evidence suggests that the major energy suppliers are taking advantage of loyal customers on their standard tariffs. For example, the CMA's analysis shows that the gap between the average large supplier standard tariff and the two cost benchmarks used<sup>50</sup> appears to have widened over time, particularly since 2009. Regulating these tariffs would protect these customers - who are still the majority - against any unfair pricing strategies which take advantage of consumer inertia.

#### **Box 6 - Deregulation in Victoria, Australia**

The Australian state of Victoria was the first Australian jurisdiction to fully deregulate electricity prices as of 1 July 2014. Research from the St Vincent de Paul Society and Alviss consulting suggests that deregulation has not necessarily led to better outcomes for consumers.<sup>51</sup> This is based on estimates that the proportion of the bill that ends up with the supplier is between 27% to 33%. This is significantly more than the wholesale proportion of the bill (estimated at 14-16%) and studies have found that the gross retail margin for suppliers in Victoria appears to be higher than in other states.<sup>52</sup> The St Vincent de Paul Society suggest that this may indicate that competition is not leading to more efficient price setting.<sup>53</sup>

The suggestion is that the removal of regulation has led to increased profits for suppliers and higher prices for consumers. Awareness of the different options available remains low, resulting in low switching rates. Although consumers have expressed interest in shopping around for better deals, few have actually acted upon this. People expect themselves to shop around and consider all their options in order to achieve the best outcomes, but in reality they do not. Market arrangements continue to exist based on these perceptions and become increasingly misaligned with real consumer behaviour.

To drive better competitive outcomes for consumers, one proposal is to rethink the way that the standing offer is structured.<sup>54</sup> Standing offers are required by legislation in Victoria.<sup>55</sup> They are generally applied where a customer has not contacted a supplier to take out an energy tariff. Consumers can also opt to be on the standing offer but it is unlikely to represent good value. The St Vincent de Paul Society and Alviss consulting suggest that the standing offer framework could be redesigned and used to better effect so that it operates more effectively than this, helping consumers compare offers.

<sup>50</sup> The CMA used Ofgem's SMI (adjusted) and their own one year cost benchmark. The average major supplier standard tariff was tracked against these two cost benchmarks from 2004 to Q2 2014.

<sup>51</sup> St Vincent de Paul society & Alviss Consulting, The National Energy Market – wrong way, go back? Observations from the Vinnies' tariff tracking project, September 2014.

<sup>52</sup> Vinnies' tariff tracking project, p. 14.

<sup>53</sup> Vinnies' tariff tracking project, p. 10.

<sup>54</sup> Vinnies' tariff tracking project, pp. 20-23.

<sup>55</sup> <http://www.energyaustralia.com.au/standing-offer-customers>. These tariffs have a set of terms and conditions approved by the regulator and offer a 'no frills' option with no additional features such as discounts..

Standing offers in Victoria have been criticised as creating an artificial benchmark for suppliers' pricing strategies and as unhelpful comparison purposes.<sup>56</sup> The incumbent retailers have not published new standing offer rates since the end of 2013. One proposal to improve the usefulness of these offers is to impose fixed dates every six months when suppliers would have to publish their rates, and would be required to justify any price changes.<sup>57</sup> The argument is that this would allow for greater transparency and more credible benchmarks, as well as allowing greater public scrutiny of prices. This in turn should drive greater consumer engagement.<sup>58</sup>

There are clear parallels between this proposal and a Price to Beat. The fact that this idea has been suggested in a market only recently fully liberalised suggests that the problems with a competitive energy market reliant on 'rational' consumer behaviour are not confined to Great Britain.

### 3.3 Option 3: A published reference price

A Price to Beat could also be established through the introduction of a reference price or series of reference prices. As with the regulated tariff option, a price setting process would take place, which could be carried out either by the regulator or an independent authority. However under this option it would operate as a reference price only, rather than a regulated tariff (option 1). This would help to simplify the comparison process and allow consumers to anchor their decisions in a meaningful way (see box 7 below).

#### Box 7 - Reference prices and anchoring

It is widely acknowledged that reference points are used by consumers to help simplify the decision making process. A robust and fairly determined reference price can support consumers in identifying the right deal for them by providing a benchmark against which other offers on the market can be compared. The underlying psychological principle behind reference pricing is anchoring. The reference price acts as a starting point for considering the other options available and in order to judge the value of alternative products or contracts; in this case energy tariffs. There is evidence from experimental studies to show the impact of reference prices on consumer behaviour and decisions as well as perceptions of value, including what amounts to a fair price.<sup>59</sup>

This reference price would help to frame the cost of energy for consumers and anchor their decisions. Which? research consistently shows that few consumers trust that suppliers charge a fair price for energy (19%) and only 13% of people believe that the amount of profit

<sup>56</sup> Vinnies' tariff tracking project, p. 21.

<sup>57</sup> Vinnies' tariff tracking project, pp. 21-22.

<sup>58</sup> Vinnies' tariff tracking project, pp. 22-23.

<sup>59</sup> Mountainview Learning for OFT, Pricing practices: their effects on consumer behaviour and welfare, March 2010.



suppliers make is fair.<sup>60</sup> A fair, transparent reference point would lead to greater understanding of how the price consumers pay is made up and provide an independent benchmark for comparing different offers.

Establishing reference prices across different tariff types would ensure that they are useful and relevant to all consumers. This could include variable, short term fixed, medium term fixed and longer term fixed tariffs, to reflect the tariff types available on the market.

### ***Strengthening the reference price***

Reference prices represent a less interventionist option and so the incentive for suppliers to keep their prices below the Price to Beat would not be as strong as the impact of a price controlled tariff as discussed above. Which? believes that the combination of a series of independently determined, fair reference prices supported by one or more of the following requirements would be powerful in incentivising firms to compete with the Price to Beat:

- Voluntary supplier commitments to not exceed the Price to Beat.
- A requirement on suppliers to explain why they cannot beat the Price to Beat.
- The power to parachute in a ‘skilled person’ to assess tariff pricing where the regulator is unconvinced of a supplier’s justification for charging above the Price to Beat (see box 8).
- Public naming of suppliers who are investigated in this way.

#### **Box 8 - skilled person**

A Price to Beat in the form of a reference price could also be strengthened by giving the regulator the power to parachute in a ‘skilled person’ where sufficient justification for charging more than the Price to Beat was lacking. The skilled person would be qualified to assess the supplier’s pricing strategies and other cost drivers, and to assess the evidence for charging above the reference price. Its use would be at Ofgem’s discretion and it would operate as a last resort intervention, where the risk of significant inefficiency has been identified.

The Financial Conduct Authority (FCA) has the power to order a Skilled Person Review. This allows the FCA to commission a review by a Skilled Person in order for the regulator to obtain an independent view of a firm’s activities that have caused particular concern or where further analysis is needed.<sup>61</sup> Which? believes that a similar power granted to Ofgem would strengthen the Price to Beat in the form of a reference price, as the onus would be on suppliers to ensure that they had real justification for charging above the reference price.

<sup>60</sup> Which? Energy Tracker, March 2015.

<sup>61</sup> <http://www.fca.org.uk/about/what/regulating/how-we-supervise-firms/reports-by-skilled-persons>



### 3.4 Option 4: Provision of a better default option

The large sticky customer bases of the major energy suppliers indicate significant levels of consumer inertia and a tendency to stick with the default. In complex markets where this is the case, defaults can play an important role by providing a minimum level of protection against poor value deals if consumers do not, or cannot, engage (see box 9).

In this scenario, suppliers would be required to incorporate a default for standard tariffs that works in conjunction with the reference price (see option 3 above). This would happen in two parts:

- First, unless the customer elected otherwise, customers on standard tariffs would be moved to the next cheapest tariff (potentially a fixed tariff) if the price of the standard tariff went above the reference price.
- Second, the supplier would notify the customer biannually how the price of their standard tariff relates to the reference price and to the supplier's cheapest deal. A notification would automatically be triggered if the price of the standard tariff went above the reference price. The notification would also create trigger points for engagement with the market.

In its recent submission to the CMA, Ofgem cited the problem that the majority of the customers of the six major suppliers are on tariffs that provide no regular prompt to engage in the market.<sup>62</sup> Creating trigger points for these sticky customers should lead to greater mobilisation across the whole of the market and boost competition. However we recognise the limitations of information remedies and so notification can only be part of the solution.

A further aspect of this would be an offering for customers on fixed tariffs. Consumers signing up to fixed tariffs would be able to choose whether to move to the default set out above once their deal comes to an end - i.e. to a standard, unless the price of the standard is higher than the reference price. Alternatively, they could elect to move to another fixed tariff. In both circumstances the customers would be given notification that their fixed deal was coming to an end and reminded of their options.

All consumers would still be able to switch to a different tariff or supplier at any point and would still be encouraged to shop around for the best deal. As with a regulated tariff, the objective of this default option would be to provide an extra layer of protection for the stickiest energy consumers.

Which? appreciates that this option may lead to suppliers maintaining their standard tariffs in-line with the reference price. However, we believe that as long as the reference price is set efficiently, this would still provide a greater level of protection to the least engaged consumers.

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<sup>62</sup> Ofgem, Submission to the CMA: Incumbency in the retail energy market, January 2015.



### ***Exit fees***

At present, customers cannot be defaulted onto a fixed tariff and Which? does not dispute this arrangement under the current system. Defaulting people onto fixed tariffs with exit fees could result in customers being ‘locked in’ to a particular deal and so prevent switching.

However, in the context of this proposal, being defaulted to the next cheapest tariff is likely to mean that a customer is defaulted onto a fixed tariff. We would therefore propose that for customers defaulted onto a cheaper deal (which is fixed), because the price of the standard tariff had risen above that of the reference price, exit fees should be waived if they subsequently decided to switch away from this tariff. This would ensure that these consumers are not deterred from engaging more proactively.

### **Box 9 - The role of defaults**

Defaults can be used in competitive markets to help protect consumers by giving them a minimum reassurance or guarantee if they choose not to engage. These options do not have to offer the best deal and should not serve as a disincentive to shopping around. But they can offer real value to consumers who may otherwise end up on poor value deals. They can also act as a safety net for vulnerable consumers less able to make the best decision for their circumstances.

Medicare, the US social insurance programme, provides an interesting example in terms of the role that different types of default options and products can play. Following implementation, there have been concerns around the way that the auto-renewal process works. Those who bought a healthcare plan in 2014 but do not shop around for a new one in 2015 will automatically stay with the plan they originally chose, even if the price increases. Given the status quo bias that consumers often display, the concern in the US is that if a significant proportion of people are auto-renewed this could undermine the policy. This is because keeping the cost of insurance down is reliant on competition between companies, as with energy tariff prices in Great Britain. Therefore similar concerns exist. If it is the minority who are shopping around for the best deals, competitive restraint will be weak and the system will fail to keep prices down for all but a small segment of engaged consumers.<sup>63</sup>

The US government is proposing to offer those who sign up to this part of Medicare a choice of defaults for when their plan comes to an end. The options proposed are:

1. Stay with the same plan.
2. If the price increases, switch to a cheaper plan within the same category.

This would not prevent those who wanted to shop around from doing so and people would still get the best deals this way. But providing a choice of defaults would allow people to protect themselves by offering a minimum level of protection against being automatically rolled onto

<sup>63</sup> <http://www.nytimes.com/2014/11/22/upshot/change-in-health-care-law-would-take-aim-at-consumer-inertia.html?abt=0002&abg=0>



a more expensive plan. Companies should then be incentivised to compete on quality and value in order to attract customers as well as providing excellent service and default options in order to retain their custom.

The CMA should consider how the provision of default options that respond to real consumer behaviour could be applied to achieve a better balance between competition and consumer protection.

### 3.5 Option 5: Focusing on vulnerable consumers

Which? believes that all consumers should benefit from the introduction of a price to beat regime. Enacting changes that everyone can take advantage of has greater benefits in terms of competition - if a price to beat is communicated to all consumers, more people will be able to make better informed decisions and ultimately play their role as the drivers of competition.

However in order to provide help to the most vulnerable consumers, who also tend to be the stickiest, the CMA could consider a price to beat regime focused on vulnerable consumers. For example, a price controlled tariff as set out above could be introduced but only applicable to those consumers deemed to be in a vulnerable situation. As mentioned, these customers are often very sticky and either less able, or less inclined, to search the market. As a result they tend to be on some of the most expensive deals. They would therefore benefit from the reassurance of a tariff that charges a fair price. Furthermore the process of moving these customers would create a trigger point for them to think about their energy costs and this would present a timely opportunity for the provision of additional help and advice.

## 4. Addressing challenges to the introduction of a Price to Beat

Which? recognises that there are a number of challenges to the idea and implementation of a Price to Beat. However the benefits and additional protection for consumers and the wider market, as described above, outweigh these concerns.

### ***A Price to Beat will undermine innovation***

Before the introduction of the tariff cap, suppliers were able to provide as many tariffs as they liked and with a price structure of their choice. Many suppliers argued that the tariff cap would restrict innovation to the detriment of consumers. This is based on an assumption that there has been innovation to benefit consumers in the retail energy market and Which? does not agree with this view. In the past, most 'innovation' has come down to price presentation, such as offering 'no standing charge' tiered pricing. These tariffs were often held up as an example of innovation when in fact they tended to be little more than a marketing gimmick.<sup>64</sup>

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<sup>64</sup> Which?, The Imbalance of Power: the retail market, December 2012.



Which? does not believe that a Price to Beat need hamper any innovations which offer real value to consumers. For example, the development of well-designed time of use products would not be prevented by the introduction of a Price to Beat on standard tariffs. It would still provide a reference point for these customers to assess the value of different offers. Neither would a Price to Beat prevent any added benefits, such as remote heating control. Consumers will be able to better judge the value of these benefits if there is a fair, independent price against which to make comparisons.

***A Price to Beat will undermine competition by narrowing price differentials between tariffs***

A key outcome of a Price to Beat would be to focus supplier competition around this price. Which? acknowledges that this may lead to the narrowing of price differentials across the market. However Which? does not agree that this amounts to an uncompetitive market. The large price differentials we currently see appear to be mostly due to suppliers' ability to price discriminate on the basis of a lack of engagement which, furthermore, they have no incentive to tackle. In the context of a limited number of engaged consumers, we think that the large price differentials are an indicator of a lack of effective competition. Hence narrowing price differentials would be an indicator of improving engagement in the market and reduced consumer harm overall. As discussed in section 2.1, the fact that the majority of consumers could save a substantial proportion of their household energy bill by switching, yet don't switch to take advantage of this, shows the lack of effective competition.

While there may be narrowing price differentials as a result of putting pressure on standard tariffs, we would not expect to see full alignment between fixed and standard rates. This is because the hedging and purchasing strategies for these tariffs will be different and so are likely to result in different rates.

A Price to Beat would represent a fair price and therefore a credible focal point for competition, and a trusted benchmark for consumers - we would expect the regulator to keep a Price to Beat under review to ensure it is set at the correct level. Although it may appear that the narrowing of price differentials in this context would lead to an overall increase in tariff prices, it is important to take into account that a minority of consumers are on the cheapest deals at the moment.

***EU legislation will not allow price regulation in GB***

One of the major aims of the Third Energy Package is to further liberalise energy markets across the European Union. However this does not mean that regulated prices are incompatible with the legislation. A European Court of Justice case in 2008 ruled that price regulation could be compatible where it is: in the general economic interest; proportionate; clearly defined, transparent, non-discriminatory and verifiable, and where it guarantees equality of access to national consumers for EU energy suppliers.<sup>65</sup>

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<sup>65</sup> Cornwall Energy, Review of the effectiveness of competition in the Northern Ireland energy retail market, p. 15.



In Northern Ireland, price controls continue currently on the basis that a significant proportion of the market is still supplied by the incumbent - 73% of domestic electricity customers are served by Power NI and 72% of the domestic gas market is served by SSE Airtricity.<sup>66</sup>

## 5. Conclusion

It is now over a decade since the GB energy retail market was liberalised yet it is clearer than ever that the current arrangements are not working for consumers. While energy is an essential, this does not automatically equate to consumer engagement and considered choices. The vast majority - around 75% - of households are on standard tariffs. These are among the most expensive tariffs available on the market. Furthermore, most of these consumers are on standard tariffs with one of the six large suppliers. The CMA's Updated Issues Statement has shown that not only are these tariffs far more profitable than other deals offered, but the major incumbent suppliers have unilateral market power over customers on their standard tariffs.

A change is needed. We need a package of reforms that will better protect the interests of all consumers, as well as supporting effective competition. We believe that establishing a Price to Beat can, and should, form a central pillar to this to give consumers better protection against paying over the odds. While there are a number of challenges to the introduction of a Price to Beat we do not consider these to be insurmountable. The current approach is simply no longer sustainable, either for consumers or effective competition.

This paper has set out a number of options for how a Price to Beat can be implemented, including:

- A regulated tariff which would replace suppliers' standard variable tariffs.
- Price regulation of the major six suppliers' standard variable tariffs.
- A published reference price to help focus competition and anchor consumer decisions.
- The provision of better default options, working in conjunction with a reference price, to protect consumers against being defaulted onto poor value standard tariffs.
- A regulated tariff to provide extra protection for vulnerable consumers.

The objective of a Price to Beat is to make competition in the retail market work for the majority of consumers rather than just the engaged few that it currently serves. We encourage the CMA to explore these options further as it develops its remedies.

**Which?, March 2015**

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<sup>66</sup> Cornwall Energy, Review of the effectiveness of competition in the Northern Ireland energy retail market, p. 52.

## Briefing

# Simple Pricing

## Helping consumers to make better energy choices

Despite the high levels of concern about energy prices, switching levels in the market are not as high as they could be and most people are on standard variable tariffs. The challenges people face when seeking out a cheaper energy deal remains a key barrier to engagement. Simple energy pricing - where gas and electricity prices are shown as a single rate per kWh - would offer far greater clarity and should lead to better switching decisions.

Which? has worked with EDF Energy to conduct new research which demonstrates that simple pricing would more than double the number of consumers able to choose the cheapest energy tariff compared with the existing tariff structure. Which? believes that the CMA energy market investigation should set out how best to introduce simple pricing as part of their package of remedies.

Energy prices continue to be the top concern for consumers, with 62% of consumers worried about them.<sup>1</sup> 54% of people find it difficult to compare the prices of different energy deals.<sup>2</sup> Given low levels of trust, as well as low switching rates of 12% from Q4 2013 to Q3 2014,<sup>3</sup> urgent action is needed.

New research by EDF Energy and Which? has found that consumers are more than twice as likely to make better choices using simple pricing than the current energy pricing format i.e. a standing charge and a unit rate. Our research tested consumers' ability to identify the cheapest deal using a price comparison website and found that 91% were able to do so when presented with simple pricing. However, only 43% of respondents were able to identify the cheapest deal using the current energy tariff format.

These results were replicated when our research tested consumers' ability to identify the cheapest deal using a pricing table format - i.e. similar to best buy tables for financial products found in newspapers. 87% of respondents were able to choose the cheapest tariff with simple pricing, compared to 35% with the current standing charge and unit rate.

### What is simple pricing?

Simple energy pricing presents each tariff as a unit rate (i.e. £ per kWh) with no separate standing charge. This means that consumers can compare the cost of energy at a glance, without needing to know their consumption - in the same way as petrol price displays.

As a result of Ofgem's Retail Market Review, currently tariffs have to be structured with a standing charge (a pence per day charge) and a unit rate (£ per kWh). Standing charges are set at different levels by energy suppliers and it is often the case that these charges will

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<sup>1</sup> Which? Consumer Insight Tracker, February 2015

<sup>2</sup> Which?/Ipsos Mori, September 2014

<sup>3</sup> DECC Quarterly domestic energy switching statistics, December 2014.

differ across an individual energy suppliers' range of tariffs. This means that to identify the best deals, consumers would have to undertake a potentially error-prone, complex, multi-step process, obtaining information about their energy costs and/or consumption and then use an intermediary such as a price comparison site to compare tariffs.

Ofgem's Tariff Comparison Rate (TCR) was intended to address this issue. The TCR is based on medium consumption and combines the standing charge, unit rate and any discounts into one figure. It is designed to help people compare the price of different tariffs, similar to the way that an APR works. However, in reality it does not act as an effective proxy for consumers to make switching decisions because it is only accurate for those with medium consumption. Therefore, basing switching decisions on the TCR could result in consumers choosing a tariff which is not cheapest for their situation. Abolishing the standing charge and introducing simple pricing would remove any need for this average rate as consumers would be able to easily identify the cheapest deal for them based on real unit prices.

#### **EDF Energy and Which? research**

EDF Energy and Which? commissioned behavioural research to understand the impact of energy pricing on consumer decisions. More specifically, the purpose was to identify whether a simple pricing structure would encourage engagement and lead to better switching outcomes for consumers.


Working together with EDF Energy, Which? commissioned research to design and conduct an experiment to understand the impact of energy tariff structure on consumer behaviour. The experiment was completed by 2,500 UK adults, responsible for choosing their energy supplier(s), weighted to the UK population. It involved two choice tasks, which simulated the process of choosing a tariff from a price comparison website and a pricing table, similar to those that appear in a newspaper. Each respondent was randomly assigned to one of nine different versions of the tasks, each with different pricing and presentation. Using a behavioural research approach rather than a traditional survey allowed us to identify what people actually do, rather than what they say they do.

Could you be saving money on your energy bills?						
Tariff Name	Electricity			Gas		
	Unit Rate (per kWh)	Standing Charge (per day)	TCR** (per kWh)	Unit Rate (per kWh)	Standing Charge (per day)	TCR** (per kWh)
<b>Brand I: Fixed Saver, Dec 2015</b> <small>1 year, fixed rate. Ends 31st Dec 2015</small>	12.15p	8.54p	13.12p	3.77p	8.54p	4.00p
<b>Brand E: Price Fix December 2015</b> <small>1 year, fixed rate. Ends 31st Dec 2015</small>	12.70p	3.64p	13.12p	3.94p	3.64p	4.04p
<b>Brand L: December 2015 Tariff</b> <small>1 year, fixed rate. Ends 31st Dec 2015</small>	11.38p	17.83p	13.41p	3.53p	17.83p	4.01p
<b>Brand D: 1 Year Fixed</b> <small>1 year, fixed rate. Ends 31st Dec 2015</small>	11.79p	18.91p	13.94p	3.65p	18.91p	4.16p
<b>Brand C: Fixed Price Energy 2015</b> <small>1 year, fixed rate. Ends 31st Dec 2015</small>	12.51p	10.50p	13.71p	3.88p	10.50p	4.16p
<b>Brand G: Fixed 2015</b> <small>1 year, fixed rate. Ends 31st Dec 2015</small>	12.27p	19.70p	14.52p	3.80p	19.70p	4.34p

All prices shown include VAT at 5%.

\*\* The TCR is the tariff comparison rate, a single rate to help you compare the price of one tariff against another. It combines the unit rate, standing charge and any discounts into a single per kilowatt hour charge. The TCR is based on medium energy consumption and so should be used as a guide only.

Fig 1: A sample pricing table

				
Below are the best tariffs available to you based on the details you have given:				
Prices displayed are for Direct Debit. Click below to choose another payment type. <input checked="" type="radio"/> Direct Debit <input type="radio"/> Cash or Cheque <input type="radio"/> Pre-payment meter				
Tariff Name	Rates	Estimated Annual cost	Estimated Savings	
<b>Brand B: 1 Year Fixed</b> <small>1 year, fixed rate. Ends 31st Dec 2015</small>	<a href="#">Click to see rates</a>	<b>£959.63</b>	<b>Save £139.96</b>	Select <input type="radio"/>
<b>Brand F: Fixed Price Energy 2015</b> <small>1 year, fixed rate. Ends 31st Dec 2015</small>	<a href="#">Click to see rates</a>	<b>£964.48</b>	<b>Save £135.11</b>	Select <input type="radio"/>
<b>Brand A: Fixed Saver, Dec 2015</b> <small>1 year, fixed rate. Ends 31st Dec 2015</small>	<a href="#">Click to see rates</a>	<b>£970.58</b>	<b>Save £129.00</b>	Select <input type="radio"/>
<b>Brand J: Fixed 2015</b> <small>1 year, fixed rate. Ends 31st Dec 2015</small>	<a href="#">Click to see rates</a>	<b>£1000.82</b>	<b>Save £98.77</b>	Select <input type="radio"/>
<b>Brand H: Price Fix December 2015</b> <small>1 year, fixed rate. Ends 31st Dec 2015</small>	<a href="#">Click to see rates</a>	<b>£1008.44</b>	<b>Save £91.15</b>	Select <input type="radio"/>
<b>Brand K: December 2015 Tariff</b> <small>1 year, fixed rate. Ends 31st Dec 2015</small>	<a href="#">Click to see rates</a>	<b>£1050.02</b>	<b>Save £49.56</b>	Select <input type="radio"/>

\* All prices shown include VAT at 5%.

Fig 2: A sample price comparison website

## The results

### Simple Pricing improves switching choices

Simple pricing makes it more straightforward to identify the cheapest tariff:

- Simple pricing more than doubled the number of respondents able to pick the cheapest tariff compared with doing the same task using the status quo of a standing charge and a unit rate. This was true for both price table choices (87% vs. 35%), like a newspaper ad, and price comparison websites (PCWs) (91% vs. 43%).
- A key reason for these improved outcomes is that consumers do not need to know their consumption before choosing the cheapest tariff for them. Ultimately, with simpler pricing, the cheapest unit rate for your payment type will be the cheapest tariff for you.

It is quicker and easier to make a choice:

- We recorded the time taken to complete each choice: a longer decision implies more effort was required. The average time people took to choose a tariff under the simple pricing structure in a flat table was 36 seconds, compared with 55 seconds for those choosing under the current pricing format.
- Respondents also found it easier to identify the cheapest deal with simple pricing in a flat table. 61% said it was easy to make a choice with simple pricing against 38% who said making a choice was easy under the status quo.

Simple pricing increased the likelihood to switch:

- Simple pricing also increased the proportion of respondents who cited their intention to switch. On the price table task, 47% said they would switch when looking at the simple pricing table, compared to 38% who saw the price table with prices structured in the current format.
- This suggests that simple pricing would have a positive impact on consumers' propensity to engage and switch to a better deal. EDF Energy and Which? believe that this would help to drive competition, putting greater downward pressure on price and increasing consumer confidence.

### Simple pricing does not harm the potential of discounts to encourage consumer engagement

The impact of simple pricing and discounts on consumer engagement:

- We also explored the impact on respondents' decisions of different ways of presenting discounts, as well as how prices were framed.
- Across all pricing structures, applying mixed discounts makes it more difficult for consumers to identify the cheapest deal. Introducing discounts also increased the time needed for consumers to compare prices using a price table format by 22 seconds.
- Discounts can be applied most effectively - both with a price table and on price comparison websites - via a simple unit price with a unit rate or percentage discount. Consumers rated this option as the easiest discount to identify the cheapest tariff. Furthermore, when discounts are applied to tariffs with simple pricing, it did not reduce respondents' intention to switch.
- Finally, although the application of discounts does reduce people's ability to identify the cheapest deal, respondents were still much more likely to identify the cheapest tariff with simple pricing than with the current tariff structure.

- With the current energy tariff structure, only 27% could identify the cheapest deal using a pricing table and only 44% could do so using a price comparison website when discounts were applied. This compares to 41% (flat table) and 65% (price comparison website) via simple pricing.

### The benefits of simple pricing

This research provides more evidence of the benefits of simple pricing to consumers and also to competition in the energy market. As such, Which? believes that it should be one of the key recommendations from the CMA.

	Simple Pricing (using a flat table)	Status Quo
Customers correctly identifying the cheapest tariff (using price comparison website)	91%	43%
Customers correctly identifying the cheapest tariff (using flat table)	87%	35%
Customers who said they felt it was “easy to make a choice”	61%	38%
Customers who said they intended to switch after choosing tariff	47%	38%
The time it took to pick the best tariff	36 seconds	55 seconds
Does the customer have to know their own consumption?	No	Yes

### Providing the foundation for an effective, competitive market

Simple pricing offers the best opportunity to make competition work by bringing instant comparability to all flat rate tariffs. People will not need to know their usage to choose the best deal for them, as the tariffs with the cheapest rates will be the cheapest for everyone, whatever their usage. This should facilitate the publication of meaningful, directly comparable energy prices across all forms of media and supplier marketing. Improved price visibility is likely to drive engagement, and ultimately competition.

### Facilitating new price promotions

In the energy market, it is very difficult for energy companies to effectively advertise their prices, since the current structure of pricing means that you cannot advertise meaningful prices at a glance. This restricts the ability of energy companies to use meaningful prices in their advertising. Furthermore, unlike in other markets such as financial services, you cannot easily compile Best Buy tables of energy tariffs.

Simple pricing would open up opportunities for energy suppliers to advertise in this way and supports the compilation of Best Buy tables. Consumers would be able to easily identify the cheapest unit price with all discounts for payment method, dual fuel or online account management included. The Best Buys would be best buys for all consumers regardless of their level of consumption.

#### Small differences through simple pricing encourage consumers to switch

Evidence from the Illinois energy market suggests that domestic consumers do make switching decisions on the basis of small differences in the unit price. Although a difference of 0.1p on a kWh seems very small, it is significant in the context of the annual bill.

#### An enabler of future market developments

Simple pricing would pave the way for more effective collective switching initiatives since it can easily establish a single 'best deal' for all participants. It should also play an important role in the introduction of new Time of Use tariffs by making these products more accessible. Displaying a single unit price for each time bracket will be simpler to understand.

#### Overall benefits for low income households

Implementation of simple pricing would deliver benefits to all consumers including the vulnerable who feature significantly among disengaged groups. As with other households, the implementation of this tariff structure would make it easier for this group of consumers to search the market and find a better deal. Low users, who are more likely to be in low income groups, currently lose out because the standing charge is a larger proportion of the overall cost. Our research showed that simple pricing benefits the most vulnerable 5% of our sample to the same extent as other consumers.

The abolition of the standing charge, as proposed under simple pricing, would put an end to this regressive system. Which? modelling in 2013 found that the impact of moving to unit pricing (which was based on average standard tariff prices at the time) would mean that low users would see their annual electricity bills fall by £23 (7%) and their gas bills by £32 (6%), amounting to a net saving of around £170m from the combined energy spend of low income households in 2013.

***For more information, contact Kate Creagh or Tom Davis***

## Which? Analysis

# Energy Wholesale Costs and Retail Prices

### Summary

There has been much debate about whether competition in the energy market is sufficient to incentivise suppliers to properly reflect reductions in wholesale costs in the retail price charged to consumers. An added complication is that all the major suppliers have longer term hedging strategies for purchasing wholesale gas and electricity that mean cost reductions to their businesses are not necessarily passed on immediately to their customers.

To establish the extent to which this is affecting consumers, Which? has analysed movements in retail energy prices over the past two years in relation to commonly used hedging strategies and real market data in the wholesale market.

In summary, our analysis suggests that:

- There was no rationale, in terms of wholesale movements, to justify the increases to gas and electricity prices in late 2013
- There has been room for the major suppliers to reduce electricity prices, based on hedged wholesale costs
- The recently announced reductions in standard gas tariff rates (of up to 5.1%) should be higher if they were to align with the wholesale market.

The analysis suggests that these factors have cost consumers up to £2.9 billion over the last year - an equivalent of £145 per annum per household on standard tariffs. Furthermore, retail price increases in 2013 appear to have been at odds with movements in the wholesale market; the increase in gas prices alone is estimated to have cost consumers £421 million per year since then.

Although the six largest suppliers have all recently announced retail price cuts, only one of these has come into immediate effect, with no price cuts to electricity tariffs. However, our analysis has found:

- Based on wholesale prices in late January 2015, there is scope for further decreases in the region of 8.8-10.3% in the price of standard gas tariffs, equivalent to a decrease of between £777 million and £907 million per annum to those households on standard gas tariffs
- Electricity prices should also be falling, with a 10% reduction appearing possible, equivalent to a saving of at least £1.6 billion a year to consumers on standard tariffs.

We conclude that the consumer detriment suggested by this analysis is a consequence of the present market arrangements. Whilst it appears from suppliers' comments that other pricing strategies - unrelated to wholesale costs - are at play, and in particular reflecting the effects of political uncertainty, in a genuinely competitive market suppliers would be forced to be more efficient and to keep their prices in check as wholesale costs fall. We have submitted our analysis as fresh evidence to the ongoing Competition and Markets Authority (CMA) investigation into the energy market, and to HM Treasury for their more recently announced inquiry.

## 1. Introduction

Energy bills are consistently rated consumers' top financial concern,<sup>1</sup> with the average household paying an annual bill in the region of £1,305.<sup>2</sup>

There are a number of components that make up the cost of energy tariffs.<sup>3</sup> Of these, the wholesale fuel (gas or electricity) costs are the single largest element. Movements in wholesale costs are cited by the energy industry as the main driver of changing retail energy prices, whilst hedging strategies employed by the suppliers in the wholesale market are said to protect consumers from volatility and energy insecurity.<sup>4</sup> In recent years, price increases have been significant: since 2004, energy bills have risen by 139% above inflation.<sup>5</sup>

Unsurprisingly, the level of wholesale gas and electricity costs, and the relationship with the price consumers pay, is a very contentious issue. Since 2008 there have been frequent debates focussing on whether decreases in wholesale costs are being passed on quickly enough to consumers, and whether retail price changes fully reflect the reduction in costs that suppliers are experiencing. In 2011, the energy regulator Ofgem concluded that there was 'evidence that customer energy bills respond more rapidly to rising supplier costs compared with falling costs.'<sup>6</sup> A joint Ofgem, CMA and Office of Fair Trading assessment in 2014 found that this 'rockets and feathers' phenomenon has become more pronounced.<sup>7</sup>

There is no simple way to determine whether the prices consumers are paying are a fair reflection of how their supplier bought their energy, with hedging strategies differing according to a range of sensitive and commercially confidential internal and external factors. Our analysis is therefore based on five different hedging strategies that typify a range of approaches that reflect supplier hedging in the GB market since 2013. These strategies (see Annex) range from a majority of the energy being purchased two years out and only 2% bought in the month of delivery, to the other end of the spectrum where most energy is bought within months of delivery and 20% within the month. The strategies were used to produce modelled, hedged wholesale costs and we have compared these costs to the wholesale element of tariffs across the last two years.

In this analysis we have excluded non-wholesale costs such as social and environmental levies. This analysis looks at the estimated wholesale costs of standard electricity and gas tariffs, which we have modelled as accounting for 47% and 51% of the tariff respectively.<sup>8</sup> Standard variable tariffs

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<sup>1</sup> Which? Consumer Insight Tracker, <http://consumerinsight.which.co.uk/>

<sup>2</sup> Supply Market Indicator, Ofgem, January 2015.

<sup>3</sup> The different elements of a tariff include: supplier operating costs, network and transmission costs, environment and social obligations, tax and wholesale costs <https://www.ofgem.gov.uk/information-consumers/domestic-consumers/understanding-energy-bills>.

<sup>4</sup> 'Prices that consumers pay are affected by the wholesale price of energy, which is the price companies pay to buy the gas or electricity they sell on to the end user. Wholesale energy prices are influenced by international events and can go up and down unexpectedly. Companies buy wholesale energy weeks, months and years in advance as well as on the day of use. This is to protect consumers from volatility in the international markets and secure enough energy to keep the lights on.' Energy UK <http://www.energy-uk.org.uk/energy-industry/energy-companies-profits-and-prices.html>. Accessed 30 January 2015.

<sup>5</sup> Which? analysis of ONS data.

<sup>6</sup> *Do energy bills respond faster to rising costs than falling costs?*, Ofgem, March 2011.

<sup>7</sup> *State of the Market Assessment*, Ofgem, OFT and CMA, March 2014.

<sup>8</sup> See Annex for details.

are the most common tariffs among households, with 74% of households on standard gas and 76% on standard electricity tariffs. While the majority of these households will be with one of the larger suppliers, our analysis looked at standard variable tariffs from all suppliers.

Finally, this analysis is not intended to replicate the analysis conducted by Ofgem and its published Supply Market Indicator (SMIs). Generally, we have sought to focus on the wholesale costs, whereas the SMI looks more broadly at supply margins. In terms of the data and methodology, the SMI looks at all tariffs, whereas our analysis focuses on standard tariffs. We used a range of hedging strategies, whereas the SMI uses a central 18 month hedging strategy, and the time period of the analysis is also different, as are the tariff wholesale proportions.

## 2. Movements in modelled hedged wholesale costs compared to retail prices since 2009

Our analysis is based on five hedging strategies for both gas and electricity, which are two year rolling hedging strategies. Set out in Charts 1 and 2 are the movements in the modelled hedged wholesale electricity and gas costs respectively, based on these strategies, from January 2009 to January 2016.

As Chart 1 below illustrates, wholesale electricity prices (shown as £ per 3,200 KWH) across all of the hedging strategies were largely flat from Quarter 2-2012 to Quarter 4-2013. However, looking further ahead, the modelled hedged wholesale electricity prices across all the strategies are projected to fall, and to fall significantly.

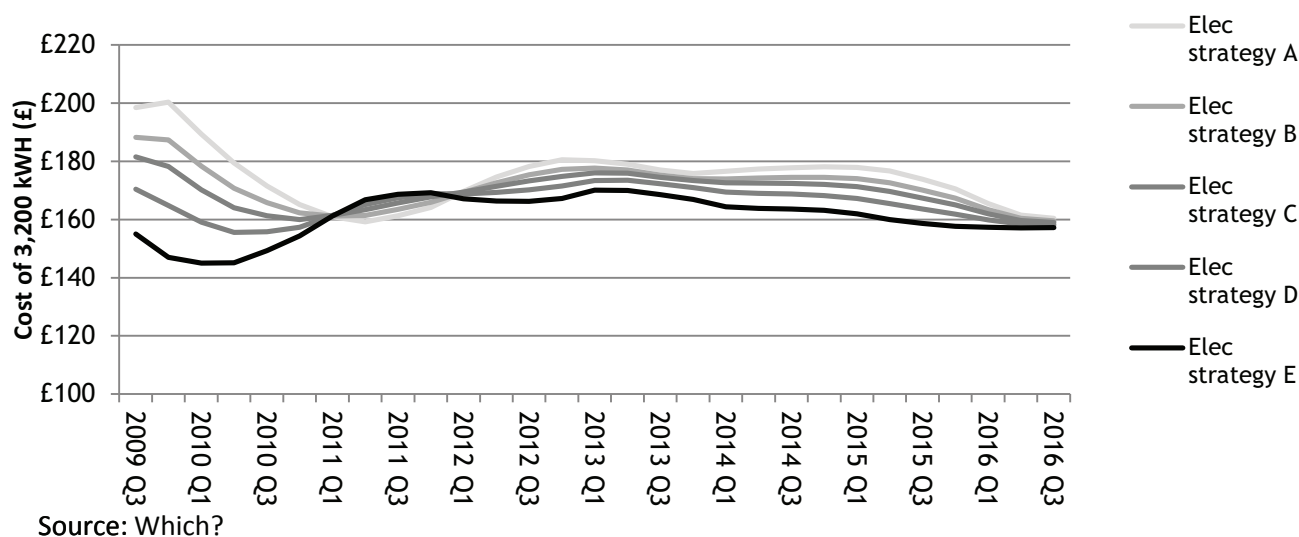
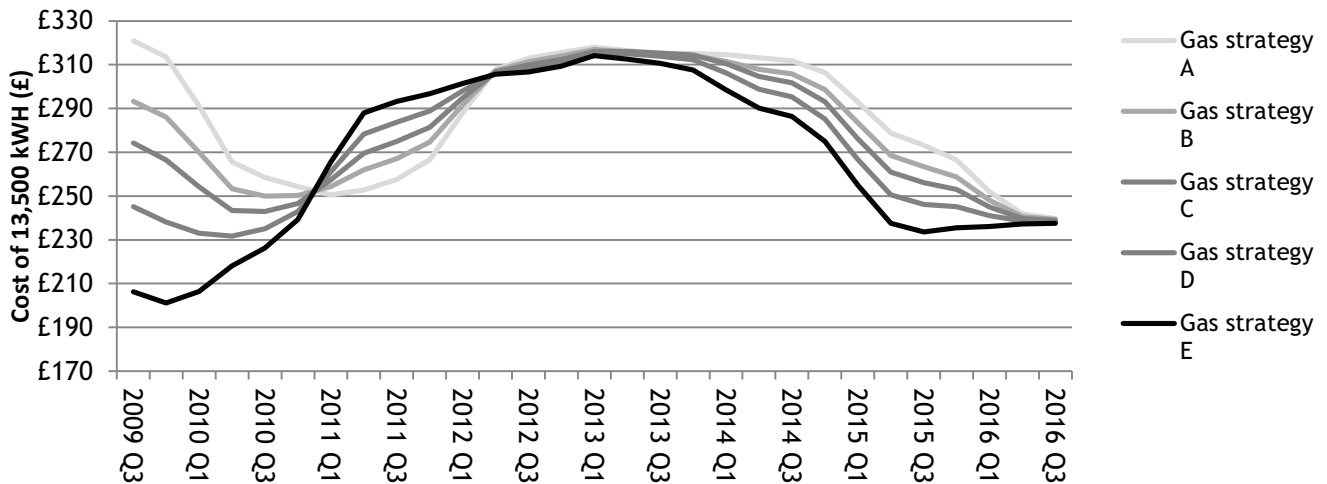


Chart 1: Modelled wholesale electricity costs for hedging strategies A-E

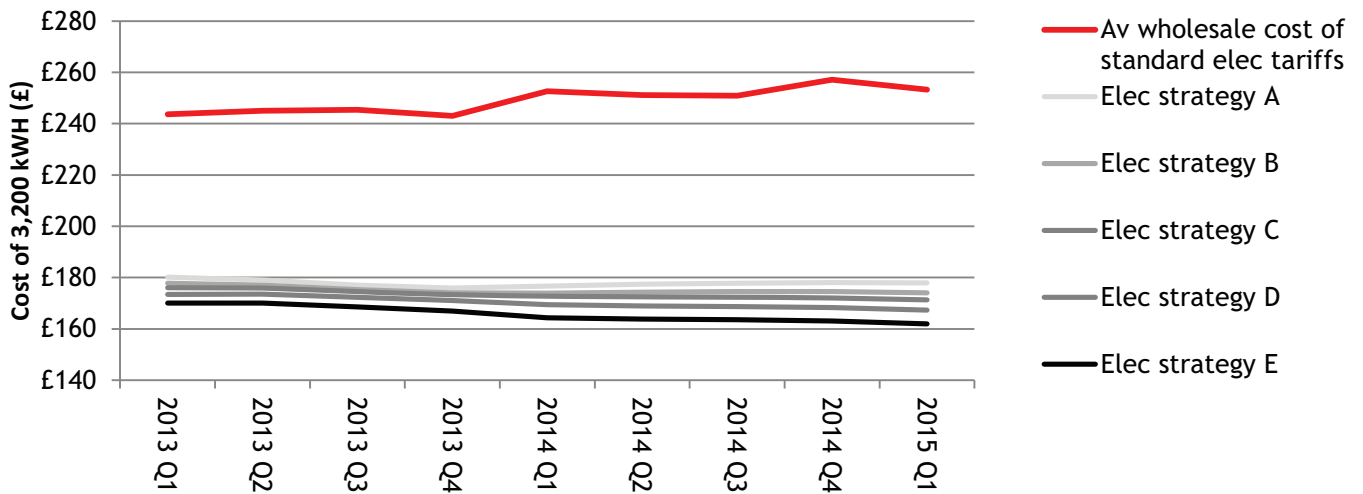
Chart 2 shows that from Quarter 1-2013 there have been reductions in wholesale gas prices (shown as £ per 13,500 KWH). Initially the decreases were small, but with larger decreases developing from Quarter 3-2013. The magnitude of the decreases grew throughout 2014 and is projected to continue to do so in 2015.



Source: Which?

**Chart 2: Modelled wholesale gas costs for hedging strategies A-E**

Set out below are the modelled hedged wholesale costs, overlaid with the wholesale element of standard variable gas and electricity tariffs, based on average quarterly price data for dual fuel, direct debit tariffs.



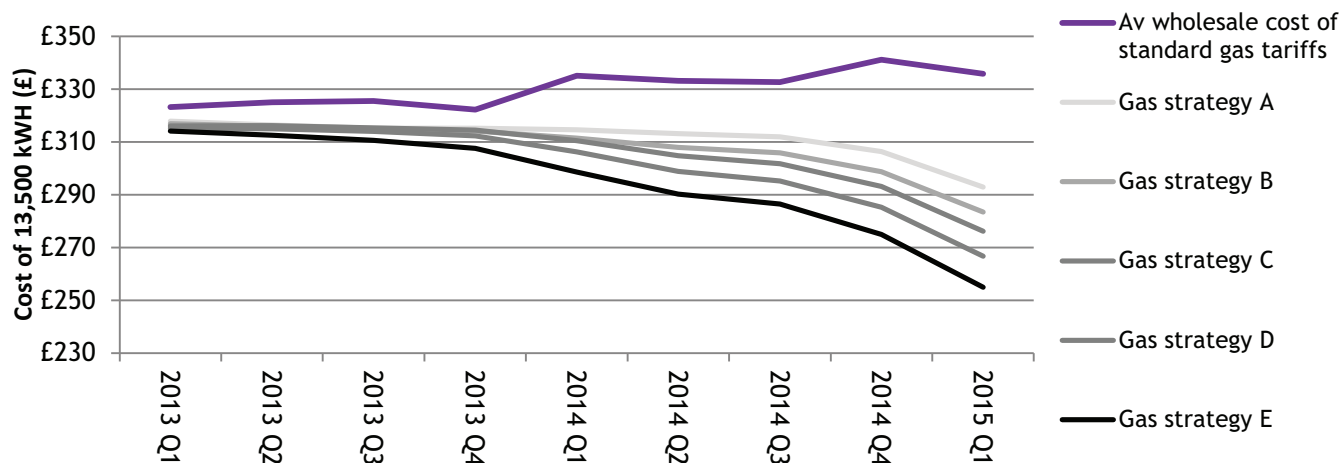
Source: Which?

**Chart 3: Average wholesale component of standard electricity tariffs plotted against A-E modelled hedged wholesale costs**

Plotted in red in Chart 3 is the average estimated wholesale component of electricity tariffs (based on all standard variable tariffs on the market and estimated as comprising 47% of the tariff) plotted against the wholesale costs (£ per 3,200 KWH) for the five hedging strategies. Chart 4 plots the

same for average gas tariff prices (in purple, the wholesale element estimated as comprising 51% of the tariff) and again in £ per 13,500 KWH.

From Chart 3 it is clear that there is a consistent and significant difference between the hedged wholesale costs and the average of the wholesale component of the standard electricity prices on offer.



Source: Which?

**Chart 4: Average wholesale component of standard gas tariffs plotted against A-E modelled hedged wholesale costs**

As with electricity, in gas there is a difference between the hedged wholesale costs and the average wholesale component of standard gas prices. However, based on this analysis, and in contrast to electricity, Chart 4 shows that the divergence appears to have begun in Quarter 4-2013.

Over the last two years there have been two significant pricing events from the six largest suppliers. Towards the end of 2013, they all announced price increases, and in recent weeks they have all announced price cuts, although only one of these has come into effect. In this section, we focus our analysis on the timing of the large suppliers' movements. There were small decreases in the hedged wholesale electricity prices from Quarter 4 of 2012 which have since continued (Chart 1). Yet it was then that retail prices increased in 2013 and the recent price cut announcements were to retail gas prices only.

Our analysis finds that a retail price cut of more than 10% off the average price of standard variable electricity tariffs across 2013-2014 would still leave a margin for suppliers of 5% on top of the wholesale costs derived from hedging strategy A (the longest run and most expensive). This would reduce bills for standard electricity tariff customers by an estimated £1.6 billion per year. Whereas a price cut that aligns retail prices to the average of the five strategies, without the 5% margin and for the year to Quarter 1 2015 would reduce electricity bills by £2.1 billion per year.

Gas prices have followed a similar pattern to electricity. As described above, prices across the five hedging strategies were initially flat, followed by small decreases from Quarter 4 2012; the rate and size of decrease in hedged wholesale costs then significantly increased (Chart 2). Consequently,

rather than raises prices at this time, it would appear that at the very least gas prices should have been held constant. If prices had been held constant at that point, the difference in the average retail gas price for all households on a standard variable tariff would have been equivalent to £421 million per year.

The recent announcements by the largest suppliers have focussed on the price of standard gas tariffs. Based on our analysis a price cut of around 5% to gas standard tariffs would not be sufficient to bring the estimated wholesale element of these tariffs into alignment with the modelled wholesale costs for January 2015. When comparing the estimated wholesale element of these gas prices to either the average wholesale costs derived from strategies A-C (the longer run purchasing strategies) or against the average of all five (A-E) modelled hedged wholesale costs, a price cut to standard gas tariff rates of 8.8% or 10.3% respectively would better bring standard gas tariff prices into alignment with wholesale costs. A reduction in prices in the range of 8.8-10.3% for the 74% of households with standard gas tariffs would equate to an estimated saving of between £777 million and £907 million a year.

### 3. Conclusions

Based on this analysis, the overall cost to consumers of the disconnect that has developed between wholesale costs and retail prices has been up to £2.9 billion over the last year. At the household level, this equates to £145 per annum for those on standard tariffs. This is based on the average quarterly difference between the estimated wholesale element of all gas and electricity tariffs and the average modelled hedged wholesale cost, from 2014 and 2015.

Despite the recent announcements of price cuts, it is clear that these will not be sufficient to bring retail prices into closer alignment with wholesale costs. To do so would imply a reduction of between 8.8-10.3% on gas standard tariffs rather than the maximum of 5% price reductions so far announced by the large suppliers.

However, this is not a new problem. This research indicates that the price increase in 2013 was at odds with the movements in the market at the time, which will have cost consumers an estimated £421 million on gas alone. A reasonable reduction in retail electricity prices could have reduced bills by at least £1.6 billion a year since 2013.

In summary, our analysis suggests that:

- There was no rationale, in terms of wholesale movements, to justify the increases to gas and electricity prices in late 2013
- There has been, and is, room for the major suppliers to reduce electricity prices, based on wholesale costs
- The recently announced reductions in standard gas tariff rates of around 5% should be higher if they were to align with the wholesale market.

This would not be possible if the market arrangements were more effective, as in a genuinely competitive market suppliers would be forced to be more efficient and to keep their prices in check as wholesale costs fall. The presence in the market of a range of smaller suppliers, offering lower prices and clearly attempting to acquire more customers, appears not to be exerting sufficient

competitive pressure on the major suppliers to make more significant and timely price cuts for their many millions of customers on standard variable tariffs.

**Which? 2 February 2015**

## Annex: Data sources and assumptions

Below is an overview of the data sources and assumptions that were used to conduct this analysis. Throughout this research we have focussed solely on the estimated wholesale element of gas and electricity tariffs. We have excluded all other variables and costs, such as social and environment levies and profits.

With the assistance of experts in the wholesale energy market, we developed five hedging strategies (A-E) that are representative of the range of different approaches used in the GB market (Table 1).

The strategies range from the more ‘traditional’ - where the majority of the gas and electricity is purchased 12-24 or so months ahead of delivery - to a more short term purchasing strategy. The more traditional approach tends to be associated with the larger established suppliers, whereas the more short term approach is more commonly associated with the smaller independent suppliers.

	24-12 months ahead of delivery	12-1 months ahead of delivery	Within delivery month
A	80%	18%	2%
B	60%	35%	5%
C	45%	50%	5%
D	25%	65%	10%
E	0%	80%	20%

**Table 1: Two year rolling hedging strategies**

This produced monthly modelled hedged wholesale costs for gas and power based on these hedging strategies from Quarter 1 January 2009 to Quarter 4 2016 and real wholesale market data. The modelled hedged wholesale costs for gas was in p/therm, and this was then converted to £/MWH for the analysis.

For this analysis, we have estimated that the proportion of a tariff that is the wholesale cost is 47% for electricity and 51% for gas.

These figures are based on the direct fuel data provided in the 2011-2013 Consolidated Segmental Statements (CSS), with a downward adjustment for non-fuel costs (for example, losses, reconciliation and balancing) based on Ofgem’s SMI. We have assumed that the wholesale proportions of tariffs did not change across the period.

We applied the same estimated wholesale proportions to all the tariffs.

As we have set out, we used the CSS to derive the wholesale cost element of gas and electricity tariffs. We consider this to be a robust source for this data. However, the way suppliers allocate their costs across their different business arms (e.g. supply, generation and trading) and within each of the business arms may vary and may change from year to year. Such differences and changes may explain the difference between the modelled hedged wholesale costs and the estimated wholesale costs of standard tariffs.

### **Tariffs and consumption profiles**

Energy bills were estimated from Energylinx domestic gas and electricity tariff data from Q1 2013 to Q1 2015, for medium users.

A medium consumption profile of 13,500 kwh for gas and 3,200 kwh for electricity (based on Ofgem's Typical Domestic Consumption Value<sup>9</sup>) was used when assessing the difference between the modelled hedged wholesale costs and the estimated wholesale element of tariffs.

To calculate the difference between the costs at a national (GB) level or for a group of customers, a £/MWH cost was derived from the difference for medium consumers. DECC domestic energy consumption statistics, and ONS household population estimates were then used to derive household extrapolations for Great Britain.

The proportion of households on standard tariffs is based on tables 2.4.2 and 2.5.2 of DECC's quarterly energy stats, December 2014.

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<sup>9</sup> *Decision: New typical domestic consumption values*, Ofgem, September 2013.