Competition & Markets Authority

ENERGY MARKET INVESTIGATION

Notice of provisional findings made under Rule 11.3 of the Competition and Markets Authority Rules of Procedure (CMA17)

1. On 26 June 2014, the Gas and Electricity Markets Authority in exercise of its powers under sections 131 and 133 of the Enterprise Act 2002 (the 2002 Act) (as provided for by section 36A of the Gas Act 1986 and section 43 of the Electricity Act 1989), made a reference to the chair of the Competition and Markets Authority (CMA) for an investigation into the supply and acquisition of energy in Great Britain.

Provisional findings

2. The CMA inquiry group (the Group) appointed to consider this reference has provisionally found, pursuant to section 134(1) of the 2002 Act, that there are features of the relevant markets, which alone or in combination prevent, restrict or distort competition in the supply of electricity and gas in the United Kingdom, and accordingly that there are various adverse effects on competition (AECs) within the meaning of section 134(2) of the 2002 Act.

3. In particular, the Group has provisionally found that the absence of locational pricing for transmission losses is a feature of the wholesale electricity market in Great Britain that gives rise to an AEC, as it is likely to distort competition between generators and to have both short- and long-run effects on generation and demand:

   (a) In the short run, costs will be higher than would otherwise be the case, because cross-subsidisation will lead to some plants generating when it would be less costly for them not to generate, and other plants, which it would be more efficient to use, not generating. Similarly, cross-subsidies will result in consumption failing to reflect fully the costs of providing the electricity.

   (b) In the long run, the absence of locational pricing may lead to inefficient investment in generation, including inefficient decisions over the extension or closure of plant. This could also lead to inefficiency in the location of demand, particularly high-consumption industrial demand.

4. The Group has provisionally found that the mechanisms for allocating CfDs are a feature of the wholesale electricity market in Great Britain giving rise to an AEC through increasing the risk of inefficient allocation of financial support to generation capacity and which adversely impacts competition. More specifically, this is due to the absence of an obligation for the DECC to:

   (a) carry out, and disclose the outcome of, a clear and thorough impact assessment supporting a proposal to use its powers to allocate CfDs outside a competitive process; and

   (b) regularly monitor the division of technologies between different pots, which form the basis of CfD auctions, and provide a clear justification when deciding on the allocation of budgets between the pots for each auction.

5. The Group has provisionally found that a combination of features of the markets for domestic retail supply of gas and electricity in Great Britain give rise to an AEC through an overarching feature of weak customer response[1] which, in turn, gives suppliers a position of unilateral market power concerning their inactive customer base which they are able to exploit through their pricing policies or otherwise. These features act in combination to deter customers from engaging in the domestic retail gas and electricity markets, to impede their ability to do so effectively and successfully, and to discourage them from considering and/or selecting a new supplier that offers a lower price for effectively the same product.

6. More particularly, these features are as follows:

   (a) Customers have limited awareness of and interest in their ability to switch energy supplier, which arises in particular from the following fundamental characteristics of the domestic retail gas and electricity supply markets:

      (i) the homogeneous nature of gas and electricity which means an absence of quality differentiation of gas and electricity and which may fundamentally affect the potential for customer engagement in the markets; and

      (ii) the role of traditional meters and bills, which give rise to a disparity between actual and estimated consumption. This can be confusing and unhelpful to customers in understanding the relationship between the energy they consume and the amount they ultimately pay. The full roll-out of smart meters over the next five years may have a

[1] We refer to weak customer response as an overarching feature as synonymous with it being a source for an AEC (*CC3*, paragraph 170).

potentially significant positive impact on engagement, although we have limited evidence concerning the likely magnitude and timescales of any such impact.

These fundamental characteristics may particularly affect certain categories of customer (eg those who are elderly, live in social and rented housing or have relatively low levels of income or education) who we observe are less likely to have considered engaging than others.

(b) Certain customers face actual and perceived barriers to accessing and assessing information arising, in particular from the following aspects of the domestic retail gas and electricity markets:

(i) the complex information provided in bills and the structure of tariffs, which combine to inhibit the value-for-money assessments of available options, particularly on the part of customers that lack the capability to search and consider options fully (in particular, those with low levels of education or income, the elderly and/or those without access to the internet); and

(ii) a lack of confidence in, and access to, price comparison websites (PCWs) by certain categories of customers, including the less well-educated and the less well-off. We note that alternative forms of third party intermediaries (TPIs), such as collective switching schemes, may become increasingly important for such customers.

(c) Customers face actual and/or perceived barriers to switching, such as where they have uncertified meters or experience erroneous transfers which have the potential to cause material detriment to those who suffer from them. Erroneous transfers may thereby impact customers’ ability to switch as well as their perception of switching. This is again an area where the introduction of smart meters should in the fullness of time help bring improvements.

(d) Prepayment meters, which place technical constraints on customers on such meters from engaging fully with the markets, and which reduce customers’ ability and incentive to engage in the markets and search for better deals. Prepayment meters therefore contribute to such customers facing higher costs and a more limited choice of tariffs. We expect these problems to be partly addressed with the full roll-out of smart meters and, in the intervening period Ofgem has recently published a report setting out measures to address the limited availability of tariffs for prepayment customers.

7. The above overarching feature of weak customer response, in turn, gives suppliers a position of unilateral market power concerning their inactive customer base. In relation to unilateral market power, our provisional finding is that suppliers in such a position have the ability to exploit such a position, for example, through price discrimination by pricing their standard variable tariffs (SVTs) materially above a level that can be justified by cost differences from their non-standard tariffs and/or pricing above a level that is justified by the costs incurred with operating an efficient domestic retail supply business.

8. The Group has provisionally found in relation to the regulatory framework governing the markets for domestic and/or small and medium-sized enterprise (SME) retail gas and electricity supply that:

   (a) The 'simpler choices' component of the Retail Market Review rules (including the ban of complex tariffs, the maximum limit on the number of tariffs that suppliers will be able to offer at any point in time, and the simplification of cash discounts) is a feature of the markets for the domestic retail supply of electricity and gas in Great Britain that gives rise to an AEC through reducing retail suppliers' ability to innovate in designing tariff structures to meet customer demand, in particular, over the long term, and by softening competition between PCWs.

   (b) The current system of gas settlement is a feature of the markets for domestic and SME retail gas supply in Great Britain that gives rise to an AEC through the inefficient allocation of costs to parties and the scope it creates for gaming, which reduces the efficiency and, therefore, the competitiveness of domestic and microbusiness retail gas supply. While we note that Project Nexus is likely to address most of the current inefficiencies in the gas settlement system identified, we are concerned at the slow pace of the implementation, the lack of a deadline and the fact that some players might have been adversely affected by these delays. Moreover, we are concerned that the incentives that shippers face to place a higher priority on adjusting AQs down and delaying adjusting AQs up will still be present after Project Nexus is implemented.

   (c) The absence of a firm plan for moving to half-hourly settlement for domestic and the majority of microbusiness electricity customers and of a cost-effective option of elective half-hourly settlement is a feature of the markets for domestic and SME retail electricity supply in Great Britain that gives rise to an AEC through the distortion of suppliers' incentives to encourage their customers to change their consumption profile, which overall reduces the efficiency and, therefore, the competitiveness of domestic and microbusiness retail electricity supply.

9. The Group has provisionally found that a combination of features of the markets for retail supply of gas and electricity to SMEs in Great Britain give rise to an AEC through an overarching feature of weak customer response from microbusinesses[2] which, in turn, give suppliers a position of unilateral market power concerning their inactive microbusiness customer base which they are able to exploit through their pricing policies or otherwise. These features act in combination to deter microbusiness customers from engaging in the SME retail gas and electricity markets, to impede their ability to do so effectively and successfully, and to discourage them from considering and/or selecting a new supplier that offers a lower price for effectively the same product.

10. More particularly, these features are as follows:

(a) Customers have limited awareness of and interest in their ability to switch energy supplier, which arises from the following fundamental characteristics of the markets for retail energy supply to SMEs:

(i) the homogeneous nature of gas and electricity which means an absence of quality differentiation of gas and electricity and which may fundamentally affect the potential for customer engagement in the markets; and

(ii) the role of traditional meters and bills, which give rise to a disparity between actual and estimated consumption. This can be confusing and unhelpful to customers in understanding the relationship between the energy they consume and the amount they ultimately pay. The full roll-out of smart meters over the next five years may have a potentially significant positive impact on engagement, although we have limited evidence concerning the likely magnitude and timescales of any such impact.

(b) Customers face actual and perceived barriers to accessing and assessing information arising, in particular, from the following aspects of the markets for retail energy supply to SMEs:

(i) a general lack of price transparency concerning the tariffs that are available to microbusinesses, which results from many microbusiness tariffs not being published; a substantial proportion of microbusiness tariffs being individually negotiated between customer and supplier; and the nascent state of PCWs for non-domestic customers (although

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[2] We refer to weak customer response as an overarching feature as synonymous with it being a source for an AEC (*CC3*, paragraph 170).

transparency may be improving with the introduction of online quotes and PCWs); and

(ii) the role of TPIs, in relation to which:

- a number of complaints have been made by non-domestic customers to various official bodies concerning alleged TPI malpractice, which may have reduced the level of trust in all TPIs and discouraged engagement more generally (although this situation may improve if Ofgem implements a code of practice for non-domestic TPIs that is currently in draft form); and

- we have noted a lack of transparency as well as the existence of incentives not to give non-domestic customers the best possible deal. We are concerned that customers are not aware of this and therefore do not take steps to mitigate it (for example, by consulting more than one TPI or seeking other benchmark prices). This is exacerbated by the lack of easily available benchmark prices, and the fact that many tariffs are not published.

(c) Some microbusiness customers are on auto-rollover tariffs (where customers are signed up for an initial period at a fixed rate, with an automatic rollover for a subsequent fixed period at a rate they have not negotiated with no exit clause), and are given a narrow window in which to switch supplier or tariff, which may limit their ability to engage with the markets. This practice has recently been discontinued by the largest suppliers, but not by some of the smaller ones (which still account for a significant share of supply of gas to microbusinesses).

11. The Group has provisionally found a combination of features of the wholesale and retail gas and electricity markets in Great Britain that give rise to an AEC through an overarching feature of a lack of robustness and transparency in regulatory decision-making which, in turn, increases the risk of poor policy decisions which have an adverse impact on competition. More particularly, these features are as follows:

(a) the lack of a regulatory requirement for clear and relevant financial reporting concerning generation and retail profitability;

(b) the lack of effective communication on the forecasted and actual impact of government and regulatory policies over energy prices and bills;

(c) Ofgem's statutory objectives and duties which, in certain circumstances, may constrain its ability to promote effective competition; and

(d) the absence of a formal mechanism through which disagreements between DECC and Ofgem over policy decision-making and implementation can be addressed transparently.

12. The Group has provisionally found a combination of features of the wholesale and retail gas and electricity markets in Great Britain that are related to industry code governance and which give rise to an AEC through limiting innovation and causing the energy markets to fail to keep pace with regulatory developments and other policy objectives. These features are as follows:

(a) parties' conflicting interests and/or limited incentives to promote and deliver policy changes; and

(b) Ofgem's insufficient ability to influence the development and implementation phases of a code modification process.

The next steps

13. The Group now invites interested parties to submit reasons in writing as to why these provisional findings should not become final (or, as the case may be, should be varied).

14. Unless otherwise specified to a party, these reasons should be received by the Group no later than 5pm on 31 July 2015.

15. Unless a different date is agreed with any party, the Group will have regard to any such reasons provided by this date in making its final decisions in this investigation.

16. The Group is today also publishing a Notice of Possible Remedies which it considers might be taken by the CMA or others to remedy the AEC it has provisionally identified, comments upon which should be received no later than 5pm on 31 July 2015 unless otherwise agreed with any party.

(signed) ROGER WITCOMB
Panel Chair
7 July 2015

Note: A copy of this notice and the summary of the provisional findings report will be placed on the CMA website on 7 July 2015. The CMA expects to publish the full provisional findings report on its website by 10 July 2015. The published version of the provisional findings report will not contain any information which the Group considers should be excluded from the report, having regard to the three considerations set out in section 244 of the 2002 Act. These redactions are indicated by [✂].

Comments should be made by email to energymarket@cma.gsi.gov.uk or in writing to:

Will Fletcher
Project Manager
Energy market investigation
Competition and Markets Authority
Victoria House
Southampton Row
London
WC1B 4AD