

## **ENERGY MARKET INVESTIGATION**

### **Summary of hearing with Ofgem on 31 March 2015**

#### **Observations on updated issues statement**

1. The Office of Gas and Electricity Markets (Ofgem) welcomed the direction of the updated issues statement and was broadly comfortable with the analysis of the wholesale market and subsequent conclusions regarding the first three theories of harm.
2. Ofgem was particularly keen for the Competition and Markets Authority (CMA) to reach a definite conclusion on compatibility of competition and vertical integration.
3. Ofgem noted that it would be important to discuss cash-out prices, given the decision Ofgem was announcing that day on cash-out reform.
4. Regarding retail, Ofgem was pleased that the CMA was focusing on incumbency and sticky customers and offered to share its work on trying to address potential issues through improving consumer engagement. Ofgem expressed interest in knowing the CMA's conclusion on profitability in the retail market. It was also pleased to note the focus on code governance, which it was doing its own piece of work on, and noted that further changes might be necessary, which could be beyond Ofgem's powers. The CMA's input would be welcome on the need for such changes.
5. Ofgem commented that clarity of its duties was not particularly mentioned in the updated issues statement but was hopeful that the Strategy and Policy statement would provide this clarity. It expressed a desire for the CMA to consider the compatibility of Ofgem's duties and powers with the analysis and eventual remedies proposed by the CMA.

#### **Updated theory of harm 1: market rules and regulatory framework in the wholesale market**

6. Ofgem confirmed that there would be no significant benefit in returning to a compulsory pool rather than maintaining the existing market arrangements.
7. Ofgem explained the dual functions of Reserve Scarcity Pricing and the Capacity Market and their complementary nature. In the longer run, Ofgem

would like to reduce the extent to which market participants rely on the Capacity Market to recover their costs; however they noted there were different views as to whether dependence on the Capacity Market could be altogether removed.

8. In some instances, eg an energy-only market such as the Nordic electricity market, there was no market-wide Capacity Market framework. There was ongoing debate within Europe as to whether capacity auctions or capacity markets should be permitted across the EU. Ofgem noted that with the advent of zero marginal cost renewable plant, capacity markets might be necessary to enable thermal generators to recover their costs. The Nordic electricity market had a considerable amount of renewable energy and did not require a market-wide capacity auction. In the long run, Ofgem would like some form of real-time market with prices that can rise to Value of Lost Load.
9. Ofgem said that cash-out prices were reflected in intra-day prices in the market. It wished to ensure that the cash-out price was as cost-reflective as possible and any inappropriate actions or costs were stripped out; that was what the Electricity Balancing Significant Code Review (EBSCR) was all about.
10. Reserve Scarcity Pricing really came into play and had an impact on the cash-out price at times of system stress. The risk that this could incentivise a generator to spill energy in the hope that they received a high cash-out price would entail significant risk for a generator and hence would be unlikely.
11. With regard to contracts for difference, Ofgem highlighted the benefits of a technology-neutral auction and would like to see further steps in this direction. Technology neutral did not necessarily mean the same type of contract for everyone. Ofgem noted questions about whether all kinds of capacity were treated the same in the way the current Capacity Market was designed.
12. Locational pricing had potential strong advantages. Ofgem did not envisage detailed work on it in the near future, but would keep it under review when looking into the appropriateness of current bidding zones under EU rules. The Capacity Allocation and Congestion Management framework would be used as a basis for any investigation. Any investigation would not focus just on the constraints but also on Balancing Services Use of System charges and losses, as well as the overall bidding zone configuration.
13. Ofgem's previous decision not to accept the recommendation to account for losses should not be taken as indication of any future decision.

## **Updated theory of harm 2: market power in electricity generation leads to higher prices**

14. Ofgem agreed with the initial view put forward by the CMA that there were no significant issues associated with market power in the wholesale electricity market and it was comfortable with the analysis of generation profits that the CMA had conducted.

## **Updated theory of harm 3a: opaque prices and low liquidity in wholesale electricity markets**

15. Ofgem was monitoring Secure and Promote via a qualitative and quantitative evaluation framework and did not intend to make any adjustments until at least 2017 in order to ensure stability and encourage new traders into the market.
16. Ofgem was carefully tracking whether mandatory market maker arrangements were concentrating trades into windows of trading. Its evidence was not yet conclusive but evidence was being shared with the CMA as it emerged to assist the CMA form an opinion on whether financial players were deterred from taking part in the market because of the way it was organised.
17. Ofgem stressed that there were numerous factors impacting financial players' willingness to enter the wholesale market, for example, European financial regulations, and the configuration of trading windows were unlikely to be a central driver of lack of participation by these players.
18. Ofgem commented that it would like the level of liquidity to be better but believed that at its current level, it was not a critical problem for competitiveness in the relevant markets. Secure and Promote was an effort to improve the position. Its key focus was access to products for independent players, ie independent retailers, rather than pursuing a specific liquidity metric.
19. Ofgem noted that there had been comments from independent generators on the issue of liquidity and that several felt they might have to take on a supply business to ensure sales of their output. Ofgem had not reached a conclusive view on this point.

## **Updated theory of harm 3b: vertical integration**

20. Ofgem concurred with the CMA's initial views on vertical integration; that there was no evidence of a theory of harm. Ofgem was however focused on this

finding given the historical prominence of the issue and the ongoing debate regarding it.

21. Ofgem felt that it had to read across a number of the CMA's papers to pull together a full picture and perhaps it would be helpful to bring the analysis together. It also highlighted the question of transparency and whether people trusted the data produced by the industry, under obligation from Ofgem to produce segmental statements.
22. Ofgem asked if the CMA could perhaps do more to quash such concerns by expressing a view on the actual transparency in this area; Ofgem ceded that it had struggled to ensure trust in this area and it would, as a matter of urgency, provide any advice/opinions on how the CMA could go about this.

#### **Updated theory of harm 4: competition in the retail market**

23. Ofgem commented generally that it was glad this issue was being addressed as it had been a key concern over the past six years. The key elements that it believed to be significantly worse than in other markets were low levels of engagement, sticky customers and supplier incumbency. It was not seeking to mandate fair tariffs in the market but it did have rules for fair behaviour of suppliers under its Standards of Conduct rule. The concept of fairness and the Standards of Conduct applied to the conduct of suppliers as opposed to their pricing strategies.
24. Ofgem's concern, as set out in its paper on incumbency from December, was not price segmentation per se but the impact that price segmentation, along with sticky consumers, had on competition. It had considered how competition actually worked for new entrants (both incoming and growing) and whether competitive pressure from active consumers benefited all customers.
25. Should the CMA conclude that customers on standard variable tariffs (SVTs) were subsidising those on the fixed tariffs, the impact this would have on competition would be a concern for Ofgem.
26. The significant increase in the number of independent suppliers in recent years had brought some of the cheaper fixed tariffs into the market. Ofgem believed that this could be sustainable and could not be attributed solely to favourable wholesale market conditions. One concern was that these new players were finding it increasingly difficult to gain market share. This slowing down had encouraged them to be more innovative, which was very encouraging, for example, by partnering with Housing Associations and Local Authorities.

27. Ofgem asked whether the CMA could share its view on the fundamental question of whether, with sufficient work on consumer engagement, over time there would be enough active consumers so as not to have to worry about the incumbency issues or whether further market intervention was necessary. Ofgem concurred that the Department of Energy & Climate Change (DECC) switching campaign had some effect but that such campaigns were not likely to be an enduring part of the market.
28. Ofgem was cautious of drawing any firm conclusions on the growth of new entrants from the last two years. There had been a steady flow of customers going through the complaints process, and this had led to a flow of business for new entrants, further helped by the economically attractive wholesale market conditions; both factors that might not always be there.
29. Ofgem explained the reason for customers reverting onto an SVT following the expiration of a fixed tariff was that historically, customers coming off the fixed tariff, who did not elect an alternative, were put onto a deemed contract with what were considered to be punitive rates or a secondary fixed-term tariff at rates that customers could not get out of without paying exit charges. These practices were also happening in the microbusiness sector. The cheapest SVT was therefore seen as a better option.
30. Ofgem shared its most recent findings that 30% of electricity customers have never switched.
31. Ofgem questioned the potential characterisation of the market as suppliers acquiring a customer, paying for it and subsequently 'harvesting' it. This behaviour could be likened to the broadband market or the mortgage market.
32. Ofgem had data for both incumbent and non-incumbent electricity suppliers on what proportion of their customers had switched and how many times. There were significant differences; 77% of in-area electricity customers had never switched whereas the figure for all non-incumbent suppliers was 11% (resulting from automatic transfers due to mergers and other corporate restructurings). Ofgem was re-running the customer research and baseline data and would have the findings at the end of April. These would be shared with the CMA.
33. Ofgem was not aware of any large-scale studies on the benefits that retail competition had had for UK customers, although some academic studies in the early stages of privatisation were relevant to this question. It offered to consider this further and provide more detail if such studies were identified.
34. In terms of customer engagement, Ofgem believed that the first barrier to achieving the effectiveness of smart meters would be their actual installation.

Engaging consumers sufficiently so that they would open their door and allow a stranger into their house to fit a smart meter was not an insignificant challenge. The second barrier was considered to be ensuring that, once fitted, they actually work. This should lead to accurate bills, which would be a hugely significant step towards building confidence and trust among customers and ensuring that they feel in control of their energy costs.

35. A major issue at present was customers having the wrong meter number assigned to their property; 70% of erroneous customer transfers were due to the meter being incorrectly assigned, up from 40% in 1994. This was considered to be much higher than it should have been.
36. Ofgem was actively reviewing companies' roll-out plans to ensure they were on track for the 2020 deadline. It noted that the suppliers would need to convince Ofgem that they had thought about how they were going to complete their roll-out. Ofgem would be giving very clear signals to suppliers that were not making progress in procuring smart meters and those that were not undergoing testing and trialling at the moment. Should any company not provide a duly justified roll-out plan, Ofgem had powers to take enforcement action.
37. Ofgem was currently working as a critical friend around the technical issues that needed to be addressed and believed that some of those technical aspects of the smart metering programme were now with DECC.
38. Ofgem was not clear on whether the six largest energy firms regarded smart meters as being integral to their future commercial strategy. It was aware that all firms recognised the value that smart meters could bring but were unsure as to whether any of them were actively looking at innovative offerings for customers following the introduction of smart meters.
39. Ofgem commented that wholesale prices fell significantly over the past four to five months. Wholesale gas and electricity markets behaved as we would ordinarily have expected them to react. However, whether the retail prices reacted in the same way was less clear; the rockets and feathers issue was, therefore, still up for discussion.
40. Ofgem held that this was consistent with the idea that there was weak competition in the retail market. Over the past four to five months, wholesale prices reacted relatively as expected in an efficient market and the Supply Market Indicator (SMI) had risen dramatically from £102 to £129. The SMI had been criticised by the industry. During this period of time when wholesale prices had fallen dramatically, no commensurate retail price fall had as yet been seen.

41. The CMA highlighted the difficulty of this indicator because some retail prices had fallen, for example, the fixed-term fixed-price contracts. The problem was that 70% of consumers were not on these tariffs so perhaps at the very least, it was a problem for only some of the market.
42. Ofgem conceded that one weakness with its SMI was that it did not properly reflect the changing proportions of fixed and variable customers. It agreed that there was a strong indication of cost plus pricing when it came to standard variable prices. One explanation for prices not falling as much as could be expected was that consumers were now using less and therefore fixed costs were having to be recovered over a smaller number of units.
43. Ofgem confirmed that they did go backwards and look at whether its estimates materialised in practice by reconciling when publishing the segmental statements. This being the case, they were not necessarily closely reconciled, although suppliers appeared comfortable with its estimates.
44. Where suppliers did disagree with Ofgem was in terms of its revenue projections. This was partly to do with the shift between standard and fixed tariffs and Ofgem were tracking big supplier costs and changes in their market share. Built into SMI figures was a downward trend in consumption but this reduction might not have been as sharp as actual reductions in cost. Ofgem would share any further information on this with the CMA.
45. Ofgem stated that it had been trying to tackle the aforementioned issues in the retail market through a series of interventions. It did not think it was possible to say conclusively what impact Standard Licence Condition 25A (SLC25A) had on competition. The analysis on its effects was not sufficiently conclusive. This was due to a number of other variables impacting switching rates. Raw price differentials remained fairly wide, as did the overall gains that could be made from switching. Ofgem was concerned that the problem in the retail market was like a 'squeezed balloon': efforts to tackle it had led to it reoccurring in a different guise.
46. In hindsight, it was unlikely that Ofgem would introduce SLC25A again.
47. Ofgem recognised that the 'four tariffs' element of Retail Market Review had received the most attention. Ofgem viewed it as a 'short to medium-term phenomenon' which, had the CMA's market investigation not occurred, would likely be reviewed in 2017.
48. Ofgem confirmed that it was happy to give derogations for tariffs that assisted the vulnerable or fuel poor; in fact, such tariffs were considered a priority. Ofgem had however received very few applications for derogation since the Retail Market Review came into effect and only one direct application from

one of the six largest energy firms. Fourteen derogations had been issued in total and ten were currently in the pipeline. Ofgem however felt it was not ideal for the regulator to have to decide on a case by case basis and would like, over time, to move to a more principle-based approach.

49. Ofgem believed that regulation measured on outcomes could potentially be deliverable in the industry, albeit not without significant challenges. It was however, committed to investigating this route further. Regulation increasingly based on principles and outcomes was also contingent on complete consistency from all suppliers in certain areas, for example, detailed rules on protecting vulnerable consumers. Ofgem raised the potential concern that an industry could emerge around interpreting not just the contents of its licence but also everything it said and wrote in all contexts, including on enforcement cases.
50. Ofgem clarified that there was no legal ban on doorstep selling yet it was almost totally absent from the market, despite not being prohibited. The retreat of doorstep selling undoubtedly had an impact on falling engagement and switching in the market. It was exploring ways of potentially reintroducing face-to-face marketing to open up segments of the population that would not otherwise be reached. However, this was acknowledged as a very expensive form of customer acquisition.
51. Ofgem confirmed that it had not banned zero standing charges; it had banned multi-rate tariffs which led some suppliers to reintroduce standing charges to customers who had not previously had them. A re-emergence of zero standing charge tariffs was beginning to be seen.
52. Ofgem was working with suppliers to trial simpler telephone calls in response to comments that telephone scripts were too extensive and deterring people from switching. Ofgem was willing to explore the extent to which prescriptiveness in the licence condition was hampering a simpler bill for customers.
53. Ofgem suggested that a market with relatively high switching costs was beneficial to a large incumbent firm and hence there could be commercial interest underlying why a large incumbent might take no action to reduce switching costs. This could explain why collectively and over a period of time, the industry had not embraced the idea of making switching and customer engagement simpler. Ofgem believed it was unlikely that there was coordination here due to the individual incentives for firms.



54. Such incentives could further imply that it could also be in a firm's interest to make it difficult to switch to it. Ofgem held that higher switching costs tended to, all other things being equal, lead to slightly higher profitability.
55. Following the revision of the Confidence Code, Ofgem had not yet conducted research on how consumers might behave on being presented with all tariffs in the market on price comparison websites (PCWs). It clarified that its rules did not oblige them to show the whole market (customers could opt not to see this) as long as the PCW ensured that the choice the consumer was making was clear and transparent.
56. Ofgem did not require PCWs to disclose any commissions received. This decision was taken to ensure the balance between protecting consumers from misleading information whilst at the same time allowing space for competition, innovation and creativity. Ofgem confirmed that not all PCWs were subject to the Confidence Code.
57. Ofgem confirmed a deadline of 1 October for Project Nexus, a purely industry-led, industry-run project. A request was made last year for an extension to implementing Nexus which was rejected by Ofgem on the grounds that it had already gone on for a long time and there was no justification to further delay.
58. Ofgem was cautiously optimistic that Nexus systems would allow for many of the major problems in gas supply to be resolved but that was also contingent upon appropriate code modifications and therefore interlinked with theory of harm 5.
59. Ofgem saw the electricity settlement system as working better than the gas system but still as taking a very long time. It was keen to move to a half-hourly settlement that would require meters to be installed. It viewed the transition as beginning with the larger business customers that should already have an advanced meter. The timescale for this was 2016.<sup>1</sup> It viewed this as a learning opportunity for the industry.
60. For domestic customers, it was more complex. Ofgem did not have any current project to introduce half-hourly settlement; it was concerned about distracting people from the smart meter delivery programme that was currently on track. It commented that there was an assumption that the half-hour settlement would only be delivered if lead by Ofgem. There were small

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<sup>1</sup> To note for clarity, BSC Modification P322 has since been approved, postponing implementation until 1 April 2017, with migration starting November 2015.

players coming in and voluntarily putting customers into half-hourly settlement; there was nothing stopping this, although it did incur a cost.

61. Ofgem stated that there were significant distributional questions around half-hour settlement for which it had not yet done the policy thinking on, for example, around a two-tiered market where more active, educated customers could do well, leaving fixed costs to be recovered by the sticky, less well-informed and quite possibly vulnerable customers. Any evidence of this would be unhelpful for the momentum and eventual success of the smart metering programme.
62. Ofgem confirmed its position that there was a significant divergence between small and micro businesses, but also that it was difficult to get survey data that made the distinction easy to analyse. It believed most broker activity to be concentrated on the small end of the spectrum, rather than on the micro. It thought that microbusinesses were perhaps less engaged, more distrustful of brokers and struggled to get hold of the necessary information required to make informed decisions in the market. There was limited evidence of PCWs moving into this area. There were also very few published tariffs for small and microbusinesses as most tended to be bespoke. In reality, Ofgem suspected that businesses phoned up suppliers to ask what deal they could be offered, with insufficient information to make it a valid negotiation, therefore making it unlikely that they would receive the best deal.
63. Ofgem appreciated that these issues were fairly obvious in the market and explained that its concern in the sector was to ensure it did not over-regulate it; it relied more on information remedies to assist customers make appropriate choices.
64. Ofgem commented that the CMA's profitability work was most interesting as it had not seen such information before. It was interested to discover through the market investigation whether there was an argument based on solid evidence to support what the Federation of Small Businesses, among others, had been calling for; for the micro end of the spectrum to be treated like domestic customers, affording them the same protection that domestic customers received.
65. Ofgem confirmed that it would be supportive of doing this, should the evidence support it. It had postponed its decision pending the outcome of the CMA's proposals.
66. Ofgem noted that a helpful way to characterise the problem would be to consider whether the current split between customers who were defined as domestic and business was correct. This might be a more productive way of

looking at it than say, increased regulation on the business sector. There were, of course, differences from domestic customers, eg around the ability of a domestic customer to switch, or to protect their credit risk.

67. Ofgem confirmed that the six largest energy companies had all abandoned auto-rollover for microbusinesses and had indicated to Ofgem that they were looking to treat them more as domestic customers due to public pressure. Internal Ofgem debate regarding auto-rollovers was impacted by representations from independent suppliers regarding what a ban on auto-rollovers would do for their own business model. It considered this to be a good example of some of the tensions that existed, where applying the protections that domestic consumers had in this context could mean some suppliers leaving the market. It considered whether this would be a good time to shift from a domestic/non-domestic split to a consumption level split, with all those in the lower bracket being supplied by those suppliers currently in the domestic retail market.

### **Updated theory of harm 5: the regulatory framework and code governance system**

68. Ofgem commented that the splitting of responsibilities between itself and DECC was complex but was sufficiently clear to be workable. It believed that the Strategy and Policy Statement would be genuinely helpful to contextualise the relationship and hoped for its arrival early in the next parliament.
69. Ofgem agreed with the CMA that there was scope for assessing whether the codes could be edited and consolidated. However it argued that the real value was to be found by considering changes to the current governance arrangements. The inherently complex and interconnected nature of the industry meant that there would always be a baseline of complexity there.
70. Ofgem highlighted the introduction of the 'critical friend' role of the code administrators that was brought in following its code governance review in 2009. It would like this role to be strengthened and improved by extending best practice to ensure greater consistency across the codes.
71. Ofgem explained the central problem with current code governance centred on its potential to prevent innovation and the adoption of new business models; it was considered difficult for new entrants/those with different business models to get their views heard and accepted through a code modification process. Implementation was also noted to be very lengthy. It believed that the current governance arrangements reinforced tensions between incumbents and new entrants, rather than alleviating them. It allowed that the code governance system was good at managing incremental changes

to existing arrangements in a steady state industry but felt it was not able to deal with large-scale changes in a rapidly changing industry.

72. Ofgem commented that the Significant Code Review process did not address the issues as well as it had hoped it would. It used EBSCR as an example: three years were spent developing the proposal, then the industry did its own analysis for ten months and came to a conclusion that was different from Ofgem's, with little justification. This considerable delay meant losing ten months on implementation.
73. Ofgem contrasted this experience with the Gas Significant Code Review in which it had drafted its own code modification and then consulted with the industry which had an opportunity to comment on it. As it happens, there was industry opposition, Ofgem implemented it anyway and no subsequent appeal was made. This instance of Ofgem 'holding the pen' avoided the significant time lost to industry analysis that was seen with EBSCR.
74. Ofgem commented that even with the Significant Code Review, there was scope for the industry to delay something very significant being pushed through, for example, half-hourly settlement.
75. Ofgem noted that it did not have the powers in the Electricity Act that it had with gas. Instead of extending such powers, it considered whether pushing for code administrators to have greater responsibility for being more coordinated and forward looking would be a solution. Currently, it explained that some code administrators' roles were rather passive. It did note however that commercial tensions between incumbents and new entrants remained the fundamental issue here and hence, it was probably a question of addressing powers, rather than coordination.
76. Ofgem posited the option of having code administrators that were increasingly proactive, rather than reactive, entities. They would complete scoping work into what any code modification would look like and then consult with the industry to fine-tune the details. This would surely require a change in the governance of the codes. It made clear that it was not necessarily the case that the best solution was to hand such a role to Ofgem; it was supposed to regulate the industry, not run it.
77. Ofgem confirmed that it viewed this issue as a strong priority and was pleased that the CMA had taken it up. It suggested using Australia as one example when it came to potential governance remedies if an adverse effect on competition were to be found in this area.
78. Ofgem noted that it had had a significant role in the development of the ten European electricity codes coming in over the next decade, chairing the

Electricity Working Group for the last five years. It was reasonably comfortable with where the codes had landed. Granted, they would not be straightforward to implement and some were exceptionally complex but overall would assist with moving towards a single energy market in Europe.

## **Profitability**

79. Ofgem remarked that the CMA's observations regarding indirect costs were as it would have expected; large companies were saddled with legacy systems and independent suppliers really focused on their own back-office efficiency hence the cost differences.
80. Regarding customer service cost, Ofgem was aware from conversation with new entrants that such firms had experienced 'pinch points' in customer service due to unexpected growth (they had found new business much more rapidly than they had anticipated, meaning that their business plans were not sufficiently scaled to deal with the volume of customers). Consequently, such firms had had to significantly improve their customer service offering. The CMA stated that through its research, it had been clear that there were virtually no economies of scale in customer service. Ofgem explained there might be diseconomies of scale in the industry associated with being big and old. Given also that there were no new firms entering at scale with brand new systems, it was hard to draw any firm conclusion.
81. Ofgem highlighted the evidence that suggested customers with smart meters were much cheaper to serve because they tended not to telephone to ask questions regarding their bill. It was not clear whether DECC had factored this in explicitly to its cost/benefit analysis on smart meters.

## **Concluding remarks**

82. Ofgem offered its support to the CMA as and when any remedies implementation occurred, particularly with reference to theory of harm 4 and 5. It shared a worked example of a code change (P272) to assist the CMA with theory of harm 5. It reiterated that it would be helpful for the CMA to consider Ofgem's duties and whether they were consistent with any future remedies.