ENERGY MARKET INVESTIGATION

Summary of hearing with Department of Energy & Climate Change on 31 March 2015

Observations on the updated issues statement

1. The Department of Energy & Climate Change (DECC) clarified that the Secretary of State welcomed the Competition and Markets Authority's (CMA) work on the energy market investigation, particularly regarding standard variable tariffs, microbusinesses and code governance. It reiterated the importance of considering security of supply, the need for all customers, including those most vulnerable, to benefit from competition and the importance of encouraging innovation in the sector. It highlighted the statement made by the Chancellor in the Budget document that committed DECC to responding swiftly to any recommendations coming out of the inquiry.

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

2. DECC regarded the capacity market reforms it introduced and the cash-out reforms that the Office of Gas and Electricity Markets (Ofgem) was introducing as complementary. It noted that Ofgem had designed its cash-out reforms on the basis of the Capacity Market reforms.

3. DECC acknowledged the question of overpayment as a result of having these two mechanisms in place but held that on balance, and considering the fairly inconclusive literature on the issue, proceeding with market reforms was the right strategy. Such market reforms served to increase the responsiveness of the market so that in the long run, the pressure on the capacity market would diminish, meaning capacity payments at the lowest possible level.

4. For DECC, the question in the short run centred on what market participants were factoring into their bidding behaviour in the Capacity Market; whether they were bidding on the basis of believing the cash-out reforms were to be fully implemented or not. Whilst this was not possible to ascertain, the outcome of the first auction was that the clearing prices were lower than anyone anticipated even in a situation in which it could reasonably have been expected that uncertainty about cash-out reforms would have been at their

peak. DECC believed that should Ofgem proceed as planned, the reforms would become more certain and hence the risk of overpayment would fall.

5. DECC appreciated the need to be mindful of the risks the CMA had identified but was satisfied that there was no evidence of them being manifested and hence there was no reason to deviate from the original policy intention of having both interventions.

6. DECC explained that the Capacity Market provided a straightforward payment for capacity; payment predicated on having the plant on the system, available to dispatch at times of system stress. Reserve Scarcity Pricing was not related to having capacity available but actual dispatch into the market, providing a more calibrated and timely way of reflecting immediate demand on the system, rather than the annual availability of the generation plant. It confirmed that these were theoretically consistent and reiterated that Ofgem's interventions had been explicitly predicated on the existence of the Capacity Market.

7. DECC was aware of the argument that one of the drawbacks of the Capacity Market was that penalties for non-availability were not as sharp as perhaps they could be, or that they might deter investment. It appreciated that a balance needed to be struck but also commented that such arguments had lessened since the outcome of the auction.

8. The penalty regime was not the only way DECC ensured the Capacity Market actually resulted in availability: there was also the testing regime and price signals from the energy market that provided incentives to dispatch. DECC saw this third aspect as significant and not to be underestimated.

9. DECC had been confronted with a design policy question over whether to run the auction as a single commodity auction or whether to split it into a multiple commodity single auction. It was noted that there were risks associated with either model, but these were modelled extensively in the policy design period, consulted on and were being evaluated following the first auction. There was no evidence that a 15-year contract for a new plant introduced an inefficiency, although it was something that DECC would keep under review.

10. The Final Investment Decision enabling regime was a step in managing a transition from the Renewables Obligation. Through the Final Investment Decision enabling programme, within a constrained budget, it was allocating at a lower cost to consumers through the cost of capital reductions, reflected in the strike prices. Following this, DECC moved to competitive allocation which represented a step towards full, technologically neutral competition in the future. The judgements made along the way were based on value for

money assessment, both in the short and long term. Ministers judged the longer-term value for money benefits that could be gained from encouraging the development of particular technologies and sectors against any short-term costs that were going the other way.

11. DECC was working closely with the Department for Business Innovation & Skills on such industrial strategies in the renewables sector as well as the new nuclear sector. The focus was on building the supply chains, bearing in mind the cost reduction potential of the more expensive technologies. It also highlighted the importance of considering whether any cost reduction potential was contingent on UK deployment.

12. DECC noted that the ministerial view on how hard and fast to push on renewable deployment might change the view of how to drive value for money most effectively. The most recent auction drove very good value as there were a large number of projects and very fierce competition to secure the Contracts for Difference (CfD). The supply chain and policy decisions that ministers in following parliaments make might be different and might impact on the auction approach.

13. DECC was positive about the prospects for projects that had signed CfDs as the investors concerned had entered contracts with non-delivery penalties attached. It was also noted that the investors had to invest a substantial amount and be at an advanced stage in order to get to the auctions. It was, of course, monitoring progress and would assess any risks of attrition.

14. DECC commented that there were instances where pushing too fast for competition progress could actually weaken it. For example, it had two pots for CfDs. This was to maintain strong competition between lower-cost technologies, ensuring that it was not the higher-cost technologies setting the marginal price for say, onshore wind or solar. It noted that the auction had had a pleasing outcome in that there were cost pressures on both the lower and higher-cost technologies.

15. DECC assured the CMA that any CfDs money would only be handed over once projects were up and running, hence the concern that substantial amounts of money were being handed over without planning consents being granted, was largely unfounded. It was taking a rigorous approach to bilateral negotiations through the CfDs regime.

16. Much of DECC's early policy was formulated when projected gas prices were higher than they were currently projected to be. It confirmed however that it assessed the future levels of support against different scenarios for gas prices. In the shorter run, much of the low carbon support would relate to the

Renewables Obligation, where the level of support was not related to the gas price or wholesale price. Only over time would the support connected to the CfDs regime grow in size. As and when this occurred, DECC was prepared with strong arrangements in place to manage the risks around levy control.

17. DECC stated that it did assess the value for money of individual projects against a wide range of fossil fuel prices. The gas prices that had been seen were within the range that it had modelled for its economic appraisal purposes. It also assessed the robustness of its policies against a relatively low natural gas price and concluded that the economic value of its approach remained positive.

18. DECC confirmed that there was great strategic importance for both Demand Side Response (DSR) and interconnection. Regarding DSR, it was keen to gain participation in the T-1 auction. There had been representations for changing the contract length, although it had not seen any evidence that this was necessary, interconnection had been discussed at length with the European Commission to ensure that the Capacity Market was not running against DECC’s desire for greater market integration.

19. DECC commented that it was confident in dealing with any temporary demand reduction through DSR; it was remunerating time-limited demand reduction, which was a well-established policy problem. It noted that there were more interesting policy questions around measuring permanent reductions in demand.

20. DECC clarified that the Capacity Market transformed scarcity rents in the wholesale market into a steady cash flow for generators, which were more investable. One potential development of this market structure would be a gradual evolution of Reserve Scarcity Pricing (RSP) towards what was estimated to be the true value of lost load. The further evolution of cash-out reform to the true value of lost load would crystallise the scarcity rents in the wholesale market, leading ultimately to an alternative structure, such as a reliability market. Such a market would convert those observed scarcity rents in the wholesale market into an investable cash flow that would serve the same purpose.

21. The current configuration of the market was somewhere between the two. Having raised the cash-out price under the current reforms, DECC, alongside Ofgem, was now reflecting on whether this aspect of the market worked and whether any further evolution of the system would be possible.

22. DECC believed that, if more locational pricing was considered beneficial in the near or medium term, the European framework would probably be the basis

on which this should be done. It provided the decision-making structure in terms of establishing bidding zones and the technical and economic analysis.

23. DECC agreed that additional cost reflectivity should make the system more efficient and keep costs to consumers down. Some cost reflectivity already existed in the operation of the transmission system, so the question was whether to go further. In principle, it saw the economic benefits to sharpening locational signals, but noted that there were undoubtedly costs and risks associated. One such risk was considered by Ofgem in 2010 when it looked into whether generators might be unwilling or unable to respond to price signals, meaning that any projected benefits might not materialise.

24. It was not just the consumer element, but also the fuel poverty element; fuel poverty was an extremely complicated area with different fuel poverty gaps across the country. If consumer prices fell in one part of the country, there would be a corresponding fall in the fuel poverty gap in that part of the country, but if prices were rising in another part of the country, the fuel poverty gap would increase there.

25. DECC questioned what the effect on investment would be in different parts of the country (particularly for Scottish generators), what it would mean for renewable generation or even the maintenance of current generation. It would be very interested in the CMA's understanding of the balance of costs, benefits and risks associated with locational pricing.

26. DECC made clear that the debate on locational pricing included a range of factors that needed to be taken into consideration, including complexity. It was aware of the calculations from March 2010 regarding what benefits might be gained, but believed that such studies had drawbacks. Either they were focusing on short-run benefits or reporting on the net economic benefits. While it was possible to see the purely economic benefits, it would be necessary to get underneath that to assess whether the price would actually be secured and what the cost of securing that price would be, in order to set that against other areas the CMA might want to consider.

27. DECC commented that it was interested to see the CMA's conclusions regarding the two inefficiencies here; one being the dispatch and inefficiency of the existing plant, the other being the potential inefficiencies from the location of the plant.

28. DECC explained that the Capacity Allocation and Congestion Management did not cover locational loss charging and that this issue was primarily Ofgem's concern.

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

29. DECC considered it positive that the CMA had not found signs of market power in generation. It asked how confident the CMA was in its evidence base and the modelling used to draw this conclusion. The quality and robustness of the evidence was key, as this conclusion would very likely face significant scrutiny.

30. DECC outlined that ministers are interested in value for money for consumers, security of supply and decarbonisation. DECC considered that security of supply is not a concern in the longer term. There is some concern ahead of the capacity market delivery year, but there is a clear plan with Ofgem and National Grid to address this. . .

31. Some of the market reforms mentioned by DECC could increase the commercial attractiveness of certain sorts of generation. On the renewables side, DECC was seeing a healthy pipeline of projects coming forward under the Renewables Obligation and wishing to secure Contracts for Difference. DECC was on track for the 2020 renewables targets. In terms of consumer value for money, this was positive.

32. DECC did not agree with the view that the outcome of the capacity market indicated a poor outlook for generation returns, nor that this would lead to scrapping or postponing decisions on further investment. In fact, there had been no surprises in terms of the decisions made following the auction on the future of existing plants where decisions to close had been taken. DECC concluded that the relatively low price in the capacity auction reflected a reasonably bullish sense from bidders of the non-capacity market revenues. Regarding gas plants, DECC noted it was a cycle of plant replacement and hence it expected to have a constant cycle. A forecast of plant retirements was built into the requirements put out to the market.

Updated Theory of Harm 3a: opaque prices and low liquidity in wholesale electricity markets

33. DECC commented that this area was very important and had been an area of ongoing debate in the industry for some time. It was therefore very keen for the CMA to present authoritative evidence on this theory of harm. DECC was also interested in whether the CMA could provide suggestions on any measures, beyond the provisions already in place, to improve transparency and consumer confidence in the market.

34. DECC highlighted the concern raised by independent generators that they had to rely on the six largest energy companies for off-take contracts and the need for strong evidence to underpin the CMA's conclusion that this was not in fact an issue.

35. With regards to liquidity, it was noted that independent suppliers have a range of views. It was therefore difficult to draw any firm conclusions. That being the case, a common area of contention was access to shaping products. DECC acknowledged the 'Secure and Promote' package, which was designed to address liquidity, but that it was early days.

Updated Theory of Harm 3b: vertical integration

36. DECC did not add any further comments, beyond what had previously been said, regarding the CMA's finding in relation to vertical integration..

Updated Theory of Harm 4: competition in the retail market

37. DECC welcomed the CMA's focus on the retail market as it was an important issue that the government had been very focussed on. It had worked with Ofgem to improve competition in the market and was pleased to note that there were now around 21 independent suppliers in the market.

38. DECC believed most competition took place in the fixed tariff segment of the market. The challenge had been disengaged consumers on standard variable tariffs where, despite the very significant gains to be made from switching, little increase in activity has been seen.

39. DECC was not able to comment on the CMA's query as to whether fixed tariffs were essentially being subsidised by the standard variable tariffs. It did however make clear the current government's desire for the market to be efficient and provide value for the full range of customers, including vulnerable customers, as set out in the Secretary of State's letter. DECC highlighted the effort that had been made to remedy these issues, for example, the Power to Switch campaign and the Big Energy Saving Network.

40. On evaluating the Power to Switch Campaign, DECC explained that while numbers of switches can be observed and the savings made by those by switches, it is difficult to attribute the impact beyond a simple comparison with the previous year. DECC confirmed there was an ongoing evaluation plan and would be happy to share findings with the CMA.

41. DECC commented that the small company exemption thresholds were introduced to reduce the barriers to entry and growth. The rationale was to

shield new entrants from the disproportionate costs of compliance as they had fewer customers over which to spread this cost. This had contributed to the growth of independent suppliers, several of which had now passed the customer number thresholds for Energy Company Obligation (ECO) and Warm Home Discount.

42. DECC was aware that as more suppliers were entering the market and growing, it raised questions about the fairness and appropriateness of the policy because a greater proportion of the consumer base would not be contributing to the cost of delivering the schemes. Similarly, there might be customers who were potentially eligible for the Warm Home Discount who might miss out because they were with an exempt supplier. There was therefore a trade-off between boosting competition for the benefit of all consumers and a fairness consideration about spreading the policy costs in a reasonable way. DECC was considering a call for evidence on this issue, subject to the views of new ministers. It was keen to incorporate the CMA's findings into any further work on this. It did not have any other measures planned.

43. DECC commented that it was seeing signs of interest in entering the market from local bodies, including local authorities. There might be, as on the generation side, a process of growth and exit. Potential entrants might be waiting for the outcome of the CMA's report before entering the market and this should be considered by the CMA.

44. DECC stated that there were a range of options that could be looked at for standard variable tariffs, but made clear that this would be dependent on the CMA's diagnosis of the problem. The spectrum of options was wide and the current government did not have a view on the right answer.

45. Regarding smart meters and their ability to engage customers, DECC pointed to a report it had just published called 'The Early Learning Project', which provided good evidence that smart metering increased consumer engagement with energy consumption. To date, it was not aware of any problems that had arisen from the smart metering initiative and was content with the pace of the reform.

46. DECC believed there was a strong case for half-hourly settlement to be delivered as soon as possible in order to facilitate demand-side response. This work was being led by Ofgem and DECC was keen to support it in progressing this. There was much for Ofgem to do and at this stage, it was too early to say what the precise effect, if any, would be on consumer engagement. It was noted that the benefits from demand-side response in the

smart metering business case were not contingent on settlement reform being realised, although it was held that this would further increase any benefits.

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

47. DECC acknowledged that Ofgem's actions shaped the nature of competition in the market. It commented that it was probably too early to say what the effect of the Retail Market Review reforms was. The intervention was designed to allow enough space for experimentation with innovative tariffs. It highlighted that there continued to be changes in the market, for example, greater access to consumption data and that this combined with the roll-out of smart meters meant the next government would have to think very carefully about the future of the retail market.

48. DECC was aware of the concern that Ofgem's duties complicated its decision making. Ofgem was viewed as being heavily focused on driving competition and value for consumers in the market, both on the retail and network side. DECC had a provision to define strategic outcomes for Ofgem through the Strategy and Policy Statement, but this would not be an area for debate until the next Parliament.

49. DECC was granted significant powers under the Energy Act 2013 to limit the number of tariffs available. These powers were taken to demonstrate the extent to which the government was behind Ofgem and to send a signal to the market about the government's commitment to the reform process.

50. DECC was clear that price comparison websites were an important feature of the market and encouraged the work that Ofgem was doing to ensure that consumers were confident in them (with confidence in this instance being taken to mean transparency and completeness).

51. DECC believed gas settlement systems were working well for suppliers and was not aware of any concerns. It was unable to comment on Project Nexus. It considered that any distortion of competition arising from the social and environmental obligations bearing down more heavily on electricity than gas was likely to be small. There was the potential for distortion to increase if non-traditional heating systems became more widespread.

52. DECC observed that there was an important set of questions around the distribution of costs, as opposed to benefits and the simplicity of policy. Its key concerns were the size of the levies and what those did for overall bills and affordability and what the policy was supporting in terms of energy efficiency measures in the case of ECO.

53. DECC did not actually regulate how any costs were passed through, they were calculated on the basis of electricity or gas consumption. Therefore it had no mechanical link with the electricity bill.

54. DECC highlighted the logic of CfDs and Renewables Obligation costs being passed through to electricity bills. There were some arguments for preserving such a link, rather than diluting it.

55. DECC was pressing for urgent and major reforms of the EU Emissions Trading System. The government had set out a long-term trajectory for the carbon price floor, which provided a strong signal of government intention. The structure of the CfDs meant that as carbon prices rose, the subsidy provided through the support mechanism decreased.

56. DECC was interested in the CMA's initial findings on microbusinesses. It was noted that electricity seemed to be more important to SMEs than gas. It acknowledged a lack of transparency of prices in the market and hence the difficulty of working out whether such businesses were getting a fair deal. Data highlighted by the CMA on the higher cost of auto rollover and deemed contracts was cause for concern.

57. The question of whether a microbusiness had different requirements from the market and for protection than domestic consumers was difficult to answer. DECC noted that there might not be much difference between domestic energy users and certain types of microbusinesses such as sole traders. Following the CMA's highlighting of this issue, it was likely to become an active area of work for DECC.

58. In terms of organisational priorities, DECC pointed to the Annual Energy Statement as a summary of what the government had been trying to achieve. It confirmed that the Strategy and Policy Statement did not provide it with the power to direct Ofgem, but with the power to set out strategic priorities which Ofgem must have regard to in exercising its functions; it was not set to overrule key objectives set out in primary legislation, but to provide a direction of travel. It was further noted that the Strategy and Policy Statement did not mandate priorities for Ofgem. Ofgem still had to make some difficult trade-offs and judgement calls between different objectives.

59. DECC confirmed that there was sufficient clarity within the concurrent powers to ensure that nothing fell through the gap. DECC and Ofgem worked very closely together on a wide range of issues and any gaps would be quickly identified and remedied. There was a further question over potential confusion between Ofgem's views and government views and whether it was sufficiently

clear that Ofgem was an independent regulator. DECC was clear that this was not a cause for concern.

60. DECC welcomed the CMA's extension of its investigation to codes, It was a complex area with competing interests that needed to be balanced, for example, innovation and technical complexity. Any proposed action must have clear and tangible value added.

61. DECC was aware of the difficulty that smaller organisations faced in understanding the codes and being able to engage and influence. It explained that there were some elements that had been designed specifically to assist new entrants or smaller players, but agreed that there was perhaps room for improvement.

62. There were also wider questions over the appropriate governance for overseeing changes to address challenges in the energy system. DECC would not be able to set out answers to these until the next Parliament, but was preparing itself for a conversation about the challenges in the energy system as a whole. One such area that was in the public domain was Ofgem's work on Integrated Transmission Planning and Regulation (ITPR), including whether there should be an independent system operator.

63. Although DECC would take a leading role in ensuring European reforms were implemented over the next decade, there was also a role for other players. It outlined that there was a pipeline that all these changes must go through. The first step was a discussion between national system operators, followed by a view from the Association of European Regulators. After this, it went to the European Commission and on its agreement, to the member states for final points (the comitology process).

64. DECC aimed to ensure that any substantive technical points were raised as early as possible through the industry process and then the regulator process. It would be a concern if comitology involved substantial renegotiations. The changes on the gas side at this point seemed similar to the current UK system, it was in electricity that most activity would need to take place.

65. Regarding the long-term sustainability of the new retail market entrants, DECC believed that twenty one was quite a high number, but it wouldn't discount future interest. Trust and confidence in the market and also the CMA's findings on engagement would likely impact this. It did not have a view on the total number of players in the market for efficiency.

66. DECC commented that it was difficult to know whether the recent inroads by new suppliers into the larger suppliers' customer base would, at some point in the future, result in a 'critical mass' or 'tipping point' at which consumers

would suddenly become more engaged. It was looking forward to the CMA's analysis on disengaged customers and its assessment of whether the actions it had taken to date would get consumers to such a tipping point, or whether it needed to do something different.

Profitability

67. DECC was not particularly surprised by the CMA's findings of substantially different cost bases across the larger players and among the smaller new entrants. This issue perhaps highlighted the level of competitive pressure companies were facing. Strong competition should result in more convergence of efficient practices. There might also be differences seen on the customer service side that could be attributed to consumer preference.

68. When looking at the CMA's profitability analysis on the last period, DECC observed that it was difficult to make judgements without a clear idea of what was being used as a comparison. The nature of the industry meant that there were periods when it was both more and less attractive. It was a fine line between what was considered a sensible level of profit and what level of profit suggested a competition problem. It had not set out a specific aim regarding this. It was aware of suppliers' target profit levels but they were not necessarily representative of an efficient level of profit. There was a question over what a fair price was and what a reasonable profit level was. The CMA's analysis and recommendations could be significant here in terms of framing the debate.

69. As well as the overall level of profit, there was a distributional question about where the profits were made and if this reflected where we would expect profits to be made in an efficient market that benefited all consumers. There was clearly a question here, which DECC was pleased the CMA was pursuing. The issue of rockets and feathers was also mentioned by the CMA. Again, DECC valued the work that the CMA was doing in such areas of concern.