ENERGY MARKET INVESTIGATION

Summary of hearing with Professor George Yarrow, Chairman of the Regulatory Policy Institute on 11 December 2014

Introduction

1. Professor Yarrow explained that while at Ofgem he had proposed on two occasions, in 2008 and 2009, that the energy market should be referred to the Competition Commission. He had made these proposals for two main reasons, one, that prices had been deregulated for five years, so it seemed like an opportune time to review how deregulation had worked, and two, from 2008 onwards there was increasing political concern about the market, which a Competition Commission investigation would have helped to address.

2. Professor Yarrow's view was that many of the problems in the retail and wholesale markets had been caused by poor regulatory and policy decisions.

3. In the case of the retail market, in 2008 Ofgem's approach to how it regulated the market had begun to change. Professor Yarrow considered that this change had been a mistake as it had led to the introduction of measures that harmed competition and consumers and created regulatory uncertainty. Senior decision makers at Ofgem had taken decisions, such as introducing Standard Licencing Condition 25A (SLC 25A) against the advice of advisers and non-executive directors, and had ignored the competition implications of these measures. It was important to ensure that the governance of Ofgem allowed for dissenting voices to have their concerns taken seriously and for there to be sufficient checks and balances in the decision-making process.

4. As far as the governance of the codes that underpinned the operation of the energy industry was concerned, Professor Yarrow's view was that the current set-up gave too much influence to the companies participating in the market and not enough to independent assessors.

5. As far as the wholesale market was concerned, Professor Yarrow considered that any security of supply problem had largely been created by mistakes in government policy. During the New Electricity Trading Arrangements version of the electricity market, there had been more than sufficient amounts of capacity available. He contrasted the position in electricity with that of gas, where the market had responded to concerns about indigenous GB supplies by building new gas pipelines and had not burdened the taxpayer in doing so.

His view was that the introduction of the Capacity Market had been a backward step, and that the provision of capacity for electricity should be handled in the same way as gas.

6. In future, it was important that Ofgem behaved in an authoritative and consistent manner so that market participants understood its approach and could have a useful dialogue with it. It was also the responsibility of those participants to check Ofgem by appealing its decisions when they believed that regulatory actions could be expected to have harmful consequences.

7. The energy industry was very politically sensitive and was likely to continue to be so. It was important that industry regulators were independent and strong and gave politicians unbiased and apolitical advice.

The wholesale market

Environmental measures

8. Professor Yarrow considered that those environmental policies that were additional to the European Emissions Trading System were adding to industry costs and were counterproductive as far as carbon reduction was concerned. These additional constraints simply raised prices for energy consumers and did so in a socially regressive way since energy was a higher proportion of lower-income persons spending. This would lead to a political climate in which environmental measures could become unpopular and in which people might reject further decarbonisation policies. Environmental policies should focus on making decarbonisation cheaper and should prioritise research and development of new, and cheaper, technologies rather than spending large amounts of money on rolling out measures based on current technology.

The capacity mechanism

9. Professor Yarrow did not think that the capacity mechanism would solve the security of supply problem, but much would depend on the detail of how it was implemented. He was concerned that currently the system purchased generation capacity without regard to the arrangements for energy price determination. It was also important to look at the capacity problem from the demand side and remember that large energy retailers (some of whom were also generators) were incentivised to ensure that there was sufficient generation capacity so they could fulfil their obligations to their customers. If left to their own devices, retailers might start buying energy on longer term contracts than they currently did. They would also focus on ensuring that they had sufficient capacity to cover peak demand.

Contracts for Difference

10. Professor Yarrow had originally considered that Contracts for Difference (CfDs) would be a good innovation but this presumed that they would be designed to work in support of the EU’s carbon permit system and the overall energy market. This was no longer the case, and CfDs were now a way of fixing the price of energy some years in advance separately from the actual market. This could mean that depending on what happened in the market, the price paid via CfDs could be overly high. CfDs were a way of dealing with regulatory and policy uncertainty for renewable forms of energy, as they meant that government was guaranteeing support for them, but if it became apparent that the prices agreed in CfDs were substantially too high, it was likely that government would seek to renegotiate them.

Balancing and cash-out

11. Professor Yarrow had concerns about the changes to balancing and cash-out mechanisms and that these changes might lead to increased market power for generators. Energy suppliers wanted to acquire their energy through trading with generators, not through the balancing market, as prices could be much higher. The decision to move to one megawatt pricing (PAR 1) appeared to have been taken on the basis that the wholesale market was perfectly competitive so pricing on a PAR 1 basis would be appropriate. There had been no mention of market power. He believed that the market was more complicated than had been presumed, and that when the system was tight, the new pricing model could lead to generators being able to demand a very high price for their energy from either suppliers or National Grid. When this issue had been considered previously, a decision had been taken to base the balancing price on a larger range (PAR 500) as this would serve to mitigate market power. It had also been recognised that National Grid needed some discretion to balance the grid, but National Grid had been prevented from trading in the spot market so as not to distort it.

Interaction between balancing and capacity

12. The main point to consider here was whether there was a risk of double payment in the balancing and capacity mechanisms. Because of the current reforms to the balancing system it was not clear whether such a risk would materialise. It was not clear to Professor Yarrow that the changes to the balancing mechanism, ie the move to a more marginal price, were actually addressing a real and evidenced problem with the current system.

Prices for losses and congestion

13. Addressing this issue had always proved challenging for the industry, even though it was one that had been recognised for around 25 years and for which it was arguable that the benefits of addressing would be substantial. Professor Yarrow noted that while this had been an ongoing issue, it had rarely been the most important one facing the regulator, so it had not been prioritised. Unlike some other energy markets, the GB system included signals about location in its transmission system. If changes were to be made in respect of this issue it would be important to take into account any interaction between losses and capacity payments.

Vertical integration

14. Professor Yarrow did not consider that there was evidence that the type of vertical integration between supplier and generator that characterised the six large energy firms and some other firms was problematic so far as either transparency or liquidity was concerned.

15. As far as transparency was concerned, it was important to remember that the most important issue was what consumers paid for their energy. Unless there was substantial evidence of a problem being caused by a lack of transparency in the wholesale market, then there was little need to be concerned about it. In other industries, there was no requirement for firms to separate themselves at every stage of the production or distribution chain.

16. As far as liquidity was concerned, part of the purpose of the New Electricity Trading Arrangements was to allow participants in the market to contract earlier rather than later. Electricity market participants often wanted quite specific products to meet their requirements rather than standardised ones, so it was important not to be too concerned about having a standardised product, as this might damage rather than improve the parties' ability to trade.

The retail market

Competition vs consumer protection in the energy market

17. Professor Yarrow did not consider that there needed to be a major tension between competition and consumer protection in the energy market. Competitive markets could be very flexible in addressing consumers' needs, even vulnerable consumers' needs, and offering them good deals. In most markets, goods and services were tailored to meet customers' ability to pay for them, and markets were capable of taking on board wider societal values. However, there were cases in markets where it was considered that

consumer protection might need to trump competition. In these cases, it was up to policymakers to decide what their priorities were, after making a realistic assessment of the implications for competition.

18. There was a tendency in the energy market to conflate ‘sticky’ or inactive customers with vulnerable customers. This was unhelpful, but it was not clear that it had led to poor policymaking.

Trust in the energy market

19. It was important to unpack what trust meant in the energy market. It was important that people had confidence that the market was one they could engage with in the knowledge that they would be unlikely to be ripped off. If this confidence was established; then the market would have a good reputation and people would engage with it more readily. There were three important principles that underpinned a well-functioning market: good faith, reciprocity, and informality. If all three of these principles were present; then the market would act to reduce costs for everyone involved while preserving trust.

Collective buying and switching

20. Professor Yarrow explained that since deregulation he had been disappointed that bodies like local authorities had not quickly become more involved in the market, as was the case elsewhere. This might have been partly due to the licencing system for participants in the energy market, which could make it difficult for some types of bodies to become energy suppliers and for innovations to be introduced to the market.

Nature of regulation

21. Professor Yarrow favoured a more principles-based approach to regulation in most aspects of the retail energy market over a prescriptive approach. It was better for there to be general standards of conduct that suppliers could apply across the range of their retail activities rather than prescriptive sets of rules for each one, eg customer contacts, billing etc.

22. The speed at which the industry had been deregulated had meant that it had not had the time to develop a good consumer relations culture before the introduction of environmental levies and sharp increases in energy prices initiated a period of re-politicisation. It was therefore important for the regulator to provide a lead on standards.

Competition for inactive customers

23. Competition for inactive customers did not appear to be working as well in energy as in other similar markets, such as mobile phones. Professor Yarrow believed that there would have been more active competition between suppliers for these customers had the market not suffered the effects of a number of external shocks (such as sharp rises in wholesale energy costs), the subsequent regulatory responses to these shocks, and the way environmental measures had been introduced.

24. Prior to the introduction of the price discrimination licence condition (SLC 25A), Professor Yarrow did not believe that energy suppliers held back from trying to acquire each other's less active customers. However, it was possible that the introduction of SLC 25A had led to a situation where suppliers had decided that competing for each other's less active customers was no longer worth it. Even after SLC 25A's removal, if the suppliers considered this way of behaving as being profit-enhancing they might not resume trying to acquire these customers from each other.

The Retail Market Review reforms

25. Professor Yarrow considered that the four-tariff rule restricted pricing freedoms, and that it would restrict innovation and technological change in future. While it had had some positive effects on encouraging entry by smaller suppliers, it had probably not assisted consumers very much, as in most markets consumers were usually able to work out which general types of tariffs were best for them without needing to evaluate each and every offering.

Differentiation between suppliers and the Retail Market Review reforms

26. While energy itself was a homogenous product, it was possible for suppliers to differentiate themselves in a number of ways, eg differences in services, quality, and billing. It was also possible for them to differentiate through time-of-day products. The other way of differentiating was through tariffs. Tariff differentiation had been restricted by the four-tariff rule introduced by the Retail Market Review reforms (RMR). The Retail Market Review reforms' restriction on the numbers of tariffs had assisted new entry to the market by restricting incumbent suppliers' ability to introduce new tariffs to compete with the new entrants' offers. However, this meant that many customers of incumbent suppliers would need to switch to a new supplier to get a better tariff, rather than being able to obtain a better tariff from their existing one. As a result, some customers who were reluctant to switch supplier were not able to get as a good a deal as they otherwise might have if their incumbent supplier was less restricted in the range of tariffs it could offer.

Unilateral market power and tacit coordination in the retail market

27. Professor Yarrow considered that the six large energy suppliers had a degree of unilateral market power in those regions where they were the incumbents. This was not necessarily a major problem for competition so long as they were not dominant and abusing that dominance in any way. Remedies involving forced switching of consumers to address this issue would likely lead to customers who were happy with their supplier being dissatisfied by having to switch.

28. It was possible for unilateral market power and tacit coordination to co-exist in a market at the same time. The prohibition on regional price discrimination (SLC 25A) could potentially have facilitated coordination by providing a focal point for coordination, as well as potentially supporting unilateral market power.

29. It was possible that even after SLC 25A was removed, it could still assist coordination as the focal point it created would continue to exist, and parties could still continue to coordinate around it. It would be necessary to look at actual evidence of parties' behaviour to see whether this was the case.

Price comparison websites

30. Professor Yarrow did not think that Ofgem should 'endorse' price comparison websites (PCWs), although an accreditation process that addressed concerns about misleading information being provided to consumers and the PCWs payment structure would be helpful in maintaining consumer trust, particularly as PCWs were providing information across the whole of the market.

31. Requiring PCWs to display all the tariffs available in the market would not help competition between PCWs, as it would restrict their ability to compete by making exclusive offers. Covering every available tariff could be a unique selling point for a PCW. It was arguable that if all PCWs had to carry all tariffs; then suppliers would have to pay the PCWs to show the tariffs, and as a consequence, the PCWs would be less incentivised to try to sell energy products.

32. Unless consumers were particularly vulnerable and/or unable to switch energy supplier for some clearly identifiable reason; it was better to trust their decisions about why they did or did not switch energy suppliers. The decision to switch or not to switch was based on more than just price. Switching involved effort and could involve hassle, so for some consumers it made sense for them to 'leave money on the table' rather than spend time, effort

and potentially have problems if something went wrong with the switching process.

Smart meters

33. Professor Yarrow believed that, like for retail market liberalisation more generally, the reason smart meters were now being introduced was because the technology that made them cost-effective was now available, rather than because of any major ideological shifts. The biggest single cost in the billing process was meter reading, and smart meters would help to reduce this cost. Their introduction was a signal to policymakers to stick with a market approach to the energy industry and would further reinforce the general move away from central planning.

34. While smart metering was important, the developments that would likely be more useful to the consumer involved control technologies. For a consumer, simply knowing how much energy he or she was using was not as interesting as being able to control that use, eg by being able to change the heating timer when coming home late. It was debatable whether the, ‘one-size-fits-all’ type smart meters that had been mandated by the Department of Energy & Climate Change and were currently being rolled out would be advanced enough to benefit the majority of consumers.

35. Smart meters would benefit consumers by enabling time-of-day pricing. Professor Yarrow’s view was that it should not be necessary to wait until a significant majority of domestic consumers had smart meters to introduce time-of-day tariffs. It should be possible to design a set of rules for the industry which would accommodate the presence of significant numbers of smart-metered and non-smart-metered customers allowing for tariffs like time-of-use to be introduced. It would be necessary to have transitional measures in any case, since the smart meter roll-out would be a gradual process.

Other energy markets

36. It was worth comparing other countries’ energy markets with the GB market. Professor Yarrow cited the Australian retail markets in Victoria and New South Wales as having some similar issues as the GB market in relation to consumer engagement and switching.