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CBI
THE VOICE OF BUSINESS

7 August 2015

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Sent by email
cc. Secretary of State, Amber Rudd
Ofgem Chief Executive, Dermot Nolan
Permanent Secretary to the Department of Energy and Climate Change, Stephen Lovegrove

Dear Mr Fletcher,

The Competition and Markets Authority's (CMA) publications on 7 July 2015 and in the following days, are a welcome indication of the energy market investigation's progress to date. The CBI values the opportunity to share our comments on the provisional findings, the principles on which business believes possible remedies should be based, and given those principles, our thoughts on the possible remedies proposed by the CMA.

The provisional findings demonstrate the thoroughness of the investigation to date

We welcome the thorough nature of the investigation, and the use of a wide range of information and modelling techniques for the analysis of the market. This analysis should be credible, sufficiently thorough and reliable, given the wide scope of the investigation, and will be key in drawing a line under the debate over the energy market's competitiveness and helping to restore trust in the industry. The CMA's investigation has maintained independence throughout the process, and the CBI will encourage all parties to ensure this independence is not compromised or politicised as you deliver the final report at the end of the year.

Indeed, the CMA's conduct has been positively received by the industry. The sensitivity the CMA has shown to tight deadlines, the willingness with which comment and discussion has been received and the diligence shown to the process is central to ensuring the investigation stands up to scrutiny, and industry appreciates this.

However, while we broadly accept the CMA's provisional findings, we would caution against the weight placed on the Return on Capital Employed (ROCE) profitability analysis in quantifying the magnitude of Adverse Effects on Competition (AECs) in the retail energy market. Industry has concerns about the figures produced by the ROCE analysis, and we urge the CMA to revisit this analysis. Due to the relatively low levels of capital employed in the supply of energy to consumers, in comparison with energy generation for example, other methods of assessing profitability, such as Earnings Before Interest and Taxes (EBIT) are more suitable in quantifying the impact of provisional AECs, and thus the impact required of the associated possible remedies.

Business believes that the remedies proposed by the CMA should work with the grain of the market

The energy industry is one that faces a unique challenge, of generating and delivering secure, affordable energy supplies to domestic and business consumers, while decarbonising energy generation and investing

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in the low-carbon transition. In this context, the industry has experienced periods of rapid and significant change as many political and regulatory interventions have been made in the market to attempt to overcome this challenge. However, these interventions have achieved varying levels of success and the CMA's investigation offers an opportunity to learn from this to ensure future change delivers the best possible outcomes. Building on the CMA's recent publications, industry believes remedies proposed in the final report should be based on the following five principles.

- Firstly, we urge the CMA to **maintain your focus on proportionality and possible remedies that both effectively address any provisional AEC and are not onerous to implement.** Particularly with regards to the proportionality of remedies, we urge extra care be taken to accurately quantify the impact of the provisionally identified AECs, in order that possible remedies are no more interventionist than absolutely necessary. The investigation merits a wide-ranging and in-depth evidence base, given its magnitude and importance. It is this evidence base that should be used to both quantify the impact of the provisionally identified AECs and ensure the proposed remedies are proportionate. Furthermore, efforts should be made to ensure industry and consumers understand the basis of evidence upon which the CMA produces final conclusions.

- Secondly, **new interventions should not give rise to unintended consequences.** There is evidence of previous interventions in the energy market that have resulted in unintended consequences for the industry. For example, the provisional analysis finds that aspects of the Retail Market Review reforms have had unintended consequences for innovation and product creation in the energy market, as the four-tariff limit has restricted energy suppliers' ability to offer new products to consumers. Therefore, it is important that the remedies proposed in the CMA's final report are carefully designed in consultation with industry to avoid any unintended consequences.

- Thirdly, **any remedies implemented as a result of this investigation should be pro-competition**, based on the understanding that markets can and do deliver competitive outcomes for both industry and consumers. In particular, **remedies should assure the independence of Ofgem**, to minimise regulatory risk and provide a consistent regulatory framework in which investors can be confident. Furthermore, remedies should encourage smart regulation, moving away from prescriptive intervention to mechanisms in sync with the market.

- Fourthly, while the investigation focuses much attention on consumers, and it is right that the market should be delivering the best possible outcomes for its customers, it is equally important that the remedies proposed work for industry also. These are, of course, not mutually exclusive outcomes, and we encourage the CMA to recommend **remedies that work in the interest of both business and consumers.** Increased costs to business will ultimately be borne by customers in their bills either through increased cost of capital in response to any increased market risk or in the introduction of higher costs.

- Finally, **possible remedies should be considered in a time-sensitive manner**. The energy industry is experiencing a prolonged period of significant change, and any further changes must work together in a holistic way. Therefore, remedies should be considered in the context of the wider energy landscape, avoiding a 'snap-shot' view of the energy market, and timed carefully to deliver the most beneficial outcome for industry and consumers.

Based on these principles, we welcome the opportunity to share our views on the possible remedies proposed by the CMA

Given the number and breadth of possible remedies considered by the CMA at this stage, we have focused on some key areas for consideration including; the wholesale market, consumer engagement, governance, and the cost-effectiveness and communication of energy and climate change policy to consumers.

<u>The wholesale market is functioning well, but there is some room for improvement</u>

The CBI agrees with the CMA's provisional analysis that much of the wholesale market is competitive and that key structural characteristics, such as vertical integration, have been thoroughly assessed and found not to give rise to an AEC.

Although competitive processes are important in ensuring consumers get the best value for money, there are occasions where using a competition based mechanism is not appropriate. Recent changes, such as the Contracts for Difference (CfD) auctions, have seen costs come down significantly across a range of technologies, delivering cost-effective outcomes to the benefit of consumers. However, in order to achieve a diverse energy mix, CfD auctions may not be appropriate where there are few projects competing against one another, or where projects have long lead-in times and high upfront costs. We welcome the CMA's recognition of this fact. We agree with the need to properly scrutinise projects being awarded CfDs outside of a competitive auction to ensure that they deliver value for money to consumers.

<u>Consumer engagement should be encouraged through better information and transparency, and regulation limiting consumer choice and innovation should be removed</u>

A lack of customer engagement in the market has been a long standing challenge for the energy industry and it is rightly an important area of consideration for the investigation. It is in the interest of both energy suppliers and consumers (both domestic and business), that consumer engagement is improved, and more can and should be done to put customers at the heart of the energy market. Possible remedies that encourage clear, accessible information, and offer greater consumer choice are key to making it easier for consumers to understand the energy market and therefore better engage with it.

There are a number of possible remedies suggested that could help to achieve better information and better consumer engagement. The CBI agrees with removing the 'Simpler Choices' component of the Retail Market Review (RMR) reforms, in order to encourage innovation and the creation of new products. Concerns around the proliferation of tariffs as a result of this could be mitigated by ensuring there is appropriate guidance to ensure tariffs are easily comparable for consumers, avoiding over complexity.

In encouraging consumers to be active in the energy market, simplicity and accessibility is key and information should be available through a number of channels to suit consumer preferences. Prompting consumers on default tariffs to consider moving onto a product tariff, which some suppliers already do, could be a useful tool, should it be implemented in such a way that is simple for consumers and where consumers can opt-out, so as to preserve consumer choice.

The smart meter rollout will also have a significant impact on the amount and type of information available to consumers, and it is important that the benefits of the rollout are effectively communicated to consumers. The CBI recognises that, in principle, pre-payment meter customers could benefit from being prioritised in the smart meter rollout. However, the remedy would need to be specified in a way that did not significantly increase rollout costs, and recognises that some technical challenges involved in the smart meter rollout still need to be overcome, such as installation in high-rise buildings. It is important that the benefit of prioritising pre-payment meter customers is accurately evaluated to ensure it warrants the cost of prioritising particular households.

For micro-business customers, price lists could potentially be one method of improving transparency and access to information. However, it is important to note that not all microbusinesses are homogenous in their energy consumption, or indeed credit rating, and a suitable segmentation of the market will be required to accurately reflect the offers available to them. Therefore, close collaboration with energy suppliers, some of whom already provide such a service, would be particularly helpful for this possible remedy. The CMA should also consider the benefits of microbusinesses being able to negotiate the terms of their contracts.

In an effort to increase transparency, the CMA also rightly suggests that auto-rollover contracts should be prohibited and the CBI supports this possible remedy. At the same time, Third Party Intermediaries (TPIs) should rightly be governed by rules that ensure microbusinesses receive the right information and access to the best deals for them.

<u>A transitional 'safeguard regulated tariff' is not in the long-term interest of consumers, and could have significant consequences for consumer engagement and energy suppliers of all sizes</u>

The CBI's main concern with regards to the CMA's possible remedies is the possible transitional 'safeguard regulated tariff'. A regulated tariff goes against the grain of the market, and could have a number of consequences including damaging investment confidence in the energy industry and for other UK industries by increasing regulatory risk, and disincentivising customer engagement.

In cautioning against a regulated default tariff, we encourage the CMA to consider the effect of such a transitional 'safeguard' on the long-term behaviour of consumers. The CMA's own analysis showed that customers who have switched for cost reasons (83% of those surveyed) expect a saving of between £100 and £249 when switching supplier. The mean expected saving is £174.[i] A regulated tariff would likely decrease the price differential between the 'safeguard' tariff and energy suppliers' product tariffs, reducing customers' incentive to engage with the market. The GfK Customer Survey found that at present, 73% of customers who had considered switching, but had not shopped around, agreed that switching was a "hassle [they] do not have time for". [ii] Therefore, consumers may be even less likely to engage with their energy suppliers or the wider energy market on the basis that the likely gain would not justify the time spent engaging with the market. Despite the transitional nature of the proposed remedy, the long-term effect on consumer behaviour may be highly detrimental and the behavioural impact of such a tariff should not be underestimated and warrants in-depth research.

Ultimately, regulated tariffs work against the grain of the market, and moving to a regulated tariff is in stark opposition to the direction of travel in the rest of the European Union, where the UK's energy market is seen as a leader. Informational remedies and the removal of the 'Simpler Choices' RMR regulations identified could be sufficient to encourage consumers to better engage with the energy market. More interventionist remedies should only be considered if other remedies have had time to take effect and fail to demonstrate progress. Therefore, the CBI urges the CMA to consider any additional remedies based on the principles set out above.

Enhanced protections should be focussed on 'vulnerable' customers in order to mitigate risks to competition in the wider market, and there are alternatives to a regulated tariff. Importantly, consumers who choose not to engage with the energy market are not necessarily 'vulnerable'. Therefore, once vulnerable customers are clearly defined and identified, either by receipt of certain benefits or other appropriate criteria, these customers could qualify for enhanced protections. Alternatives to a regulated tariff for supporting vulnerable customers could have less impact on competition, and an option that could be explored would be providing rebates such as the Warm Home Discount.

Should the CMA recommend a 'safeguard regulated tariff', it would be least damaging if reserved for a narrowly defined group of vulnerable customers who have been on an unregulated standard variable tariff for a suitable length of time. This would give customers who are intermittently engaged an opportunity to participate in the market to seek the best possible tariff. Furthermore, clear exit criteria would be required to identify when customers would be eligible to return to an unregulated tariff. In addition, to ensure that a significant intervention such as this would be temporary, a sunset clause would be required. It is important to note that regulated tariffs can be difficult to remove once established, and we urge the CMA to prioritise remedies that work with the grain of the market.

Better governance between industry, the regulator and other institutions could aid competition

The CMA's focus on robustness and transparency in regulatory decision-making is welcome, and better governance between Ofgem, the Department of Energy and Climate Change (DECC) and the energy industry could help to improve transparency and aid competition in the energy market. However, it is not clear that a formal mechanism for resolving disagreements between Ofgem and DECC is necessary. Instead, the independence of the regulator should be better championed by all parties. For a more detailed analysis on the CBI view of the role of the regulator, please see the annex attached.

With regards to industry codes, better governance could streamline a complex and resource intensive process, however, much of the complexity of industry codes is a reflection of the genuine complexity of the industry. Although efforts to simplify or better govern the process would be helpful, it is not clear that Ofgem playing a more active role in the implementation of industry code changes would be an effective remedy. This may in fact unnecessarily overcomplicate Ofgem's role. The cost and complexity of a non-industry body should be evaluated against preserving the status quo.

Furthermore, we have some concerns regarding the possible remedy suggesting that Ofgem provide a price comparison service. There is already a price comparison market, which should be considered in evaluating this possible remedy. An independent price comparison service could provide greater transparency, should the service be purely informational. However, this service would more appropriately provided by an independent party to avoid further complicating the role of Ofgem. We urge the CMA to consider this concern further when concluding the investigation, particularly given the suggestion that Ofgem's objectives should place more emphasis on competition.

Every effort must be made to ensure the cost-effectiveness of policies supporting the low-carbon transition, and to better communicate the costs and benefits to consumers

The CMA is right to encourage greater transparency of the costs and benefits associated with policies designed to deliver the low-carbon transition, and maintain a secure, affordable supply of energy to consumers. These policies drive change across the energy industry, decarbonising our energy generation capacity and reducing our energy consumption, and they must be implemented at the lowest possible cost to the UK's consumers and businesses.

Efforts to communicate the costs and benefits of this policy framework to consumers have not gone far enough. The CMA rightly notes that these costs have contributed significantly to increasing consumer bills over recent years. It is therefore vitally important that consumers have access to the right information about how policies affect their bills, and that it is presented in non-specialist language.

The CBI suggests building on the principle of the 'Estimated impacts of energy and climate change policies on energy prices and bills' report published by DECC on an annual basis, to deliver an annual statement on the previous and current cost of policies to consumers. The role of an independent third party should be considered to ensure the output is politically neutral. The output could be delivered in two formats, one aimed at the industry and stakeholders, and one aimed at consumers.

I would be happy to discuss these matters further, and look forward to reading the CMA's final report later this year.

Yours sincerely,

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[i] GK NOP, *Energy Market Investigation: A report for the Competition and Markets Authority by GfK NOP,* Feb 2015, p.1
[ii] GK NOP, *Energy Market Investigation: A report for the Competition and Markets Authority by GfK NOP,* Feb 2015, p.2

Summary - the business vision for regulators

Economic regulators carry out a vital role in ensuring that the competition landscape in the UK performs. They aim to bolster effective competition where possible, and to provide a proxy where circumstances make it harder to achieve. This helps uphold consumer interests.

But the recession led to a drop in living standards for most UK households. That has been a shock to consumers and although the economy is now growing again, only recently have pay increases started to ease strained budgets. Consequently businesses are being challenged to ensure markets deliver and with markets in the spotlight, regulators have been under political pressure to intervene strongly and regularly.

In response the CBI has undertaken an examination of the role of regulators, their strengths and weaknesses, and the areas in which we think changes to their functioning are necessary. The "business vision for regulators" takes a cross-market review of the regulators to highlight those areas which are ripe for change across the board. These include the need for:

- government and regulator to stick to clearly defined roles
- regulators' interventions to be less prescriptive, more proportionate, and in sync
- greater focus on continuous improvement.

Government and regulator must stick to clearly defined roles:

Regulation requires sensitive trade-offs between competing objectives. Prioritising these trade-offs is a political decision and must fall to a democratically elected Parliament with electoral accountability. The role of regulators is then to establish the best tools to fulfil these objectives. This division of labour helps to create a transparent and stable regulatory environment in which business can base investment decisions. This has benefits for the consumer too, with more efficient investment driving down long-term prices, protecting quality and fostering innovation. But with markets under pressure to perform there has been a blurring of responsibilities in some sectors.

i) Government must set clear objectives for regulators across all sectors

We would like to see government set clear and unambiguous objectives for regulators across all sectors. This gives businesses and consumers a better understanding of the intentions of government and regulator and a consistent context in which to make commercial decisions, as well as enabling users to hold the regulator to account. All of the economic regulators should be subject to statutory objectives with a single principal duty. For those regulators already working to priorities, the government should provide greater clarity around long-term policy ambitions.

ii) Government and regulator must uphold regulatory independence

Free and independent decision-making is a crucial facet of regulation. It helps to minimise the threat of unexpected market shifts as a result of interventions from politicians and so helps to drive up levels of trust, between regulators, the regulated and consumers. Where regulators hold the trust of the latter they can also act as a hub for consumers to seek information, driving more market engagement. Consequently regulators must be free to carry out their obligations without the threat of interference from politicians and the separation in the roles of government and regulator should be strictly followed. As all of the economic regulators are charged with protecting the interests of users/consumers their protection and the designation of appropriate remedies must primarily be the preserve of the regulator. But regardless of procedural guarantees, a regulator will only remain independent if it behaves independently and regulators should appreciate that the perception of independent regulation is critical to building trusted relations with both users and the public.

Regulators' interventions must be less prescriptive, more proportionate, and in sync

Independent regulation has many benefits. But it still needs to form a coherent part of wider public policy or its predictability can be diluted. Technological developments are driving rapid change and regulatory frameworks and broader policy objectives must evolve to reflect contemporary economic and social priorities. An inward-facing regulatory framework is unlikely to lead to successful or predictable outcomes for businesses or consumers.

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i) Regulators should trust in competition and avoid overly prescriptive rules

Competition among existing and new market participants is the critical driver of performance and innovation. It benefits both consumers and businesses by enabling us to choose from an array of higher quality products at lower prices. And it encourages the adoption of innovation resulting in a greater range of goods for consumes.

Regulation is clearly essential where competition is absent, as in network scenarios, and the need for it in such circumstances is not in question. But in other situations regulators should ensure they take a balanced approach and explore lesser alternatives, such as self or industry regulation, before ex ante regulation is introduced. All of the regulators must demonstrate trust in competition to achieve the best outcomes for consumers and ensure regulation is a last resort after all other avenues have been explored. Businesses want to see a targeted, proportionate and customer-focussed approach to regulation that allows them to comply with those regulations that are necessary while tailoring their response to their own business needs and enabling them to innovate.

ii) Regulators must act on a strong evidence base

Consultations and regulatory impact assessments (RIAs) play a vital role in reinforcing transparency and provide business with the opportunity to feed in their views. They should enable all parties to see the reasoning behind decisions and demonstrate extensive and high-quality economic analysis. Ultimately this leads to better policy for both businesses and consumers. Given the significance of these outputs there is a need for greater consistency in the quality of RIAs and consultations both within and across the economic regulators. There must be a strong focus on economic rigour and a clear rationale for decisions.

iii) **Regulators must build a transparent, efficient and holistic work programme**

Where business has visibility of both near and long-term work schedules from across the regulatory framework it provides them with an informed view on which to base investment decisions and ensures that they can manage resources efficiently. Regulators must adopt better oversight of the spacing of market studies and investigations and the remedies likely to be employed in order to limit the extent to which businesses are subject to duplicate or simultaneous data requests and to ensure that regulations have a chance to bed in before new rules are added to the market. As such, regulators must ensure that they are more joined up, both in the spacing of their projects and programmes and in the remedies that they are likely to employ. Regulators should be clear that frequent changes to regulatory structures create uncertainty. Regulations need a chance to bed in to allow industry and consumers to feel the full effects of change and assess if modifications are functioning in the anticipated manner.

Regulators should encourage continuous improvement

At a time when markets and regulators face intense scrutiny regulators must offer efficiency and value for money. A coherent framework against which to judge regulatory performance is crucial to help assess whether this is the case.

i) **Regulators must be better at evaluating their own performance**

Self-assessments are crucial in ensuring that regulators are able to establish the areas in which they are performing well and those less strong. They also offer an opportunity for businesses to feed experience in and so can help to create better relations. Business would like to see a more honest, systematic and robust assessment of regulatory performance across markets. While we do not support the creation of a super regulator we think there is scope for the UK Regulators Network to step in here.

ii) **Regulators and industry should create more dialogue**

Businesses rely on swift and clear responses in their dealings with regulators, allowing them to self-regulate and to contribute to decision-making which prioritises the needs of the consumer. Business appreciates the opportunity for candid conversation with working-level personnel, as well as official group meetings with senior leadership. But at the same time regulators expect the same in return, so businesses should ensure that they are proactive in offering solutions and learnings around some of the areas in which they would like to see improvements. We need to see more examples of open dialogue between business and industry, to include organisations of all size. This must be conducted in a transparent fashion and in full view of other players, to mitigate against allegations of regulatory capture.