

ENERGY MARKET INVESTIGATION

Summary of hearing with the Department of Energy and Climate Change on 6 August 2015

Response to provisional findings report

1. The Department of Energy and Climate Change (DECC) said that its focus was to ensure that consumers, including microbusinesses, received the best possible deal on energy bills. Ensuring effective competition was integral to that aim.
2. DECC noted that the provisional findings covered a number of DECC policy areas and it welcomed the provisional conclusions regarding the design of the capacity market and that the move from Renewables Obligation to Contracts for Difference (CfD) was a positive step. The Competition and Markets Authority's (CMA's) detailed provisional findings that competition in the wholesale electricity market was working well and that vertical integration did not have a negative impact on competition were very important with regard to DECC's own policy areas.
3. DECC was not surprised by the findings on retail market engagement and welcomed the large body of evidence the CMA had accumulated. DECC agreed that the introduction of smart meters would have a positive effect on customer engagement.
4. The microbusinesses findings highlighted the significant differentials between the acquisition and retention tariffs and out-of-contract and deemed tariffs.
5. DECC was also keen to investigate the question of DECC and Ofgem interaction.
6. DECC believed that it was important that the different remedies fitted together to make a coherent whole. The energy sector was subject to a number of regulatory burdens and the sequencing and introduction of any remedies needed to be carefully considered.

Contracts for Difference

7. DECC welcomed both the CMA's endorsement of the move towards a more competitive CfD framework, and its acknowledgement that there were situations where bilaterally negotiated CfDs were appropriate.

Remedy 2a – DECC to undertake and consult on a clear and thorough impact assessment before awarding any CfD outside the CfD auction mechanism

8. With regard to remedy 2A, DECC agreed that where it believed it might be necessary to proceed down the bilaterally negotiated route rather than a competitively allocated route it would be reasonable to provide transparency by explaining the case for doing so ahead of a final decision being taken. However, DECC did have some concerns regarding the implementation of remedy 2a as currently formulated and how it would work in practice.
9. The decision to use a bilateral or competitive process was influenced by the competitive environment that existed in a particular sector. In situations where there were very few projects of a comparable type available, competition might not be effective and a bilateral allocation was more appropriate. A bilateral allocation was also more appropriate where the dynamics of a sector were such that DECC was not certain that competition would work.
10. Setting out the logic for a bilateral process would assist transparency and provide greater accountability and discipline on the decision-making process. DECC believed that the level of public engagement suggested by the remedy was less appropriate for bilateral negotiations. It was difficult to adopt the same level of transparency for an allocation where the commercial details and financial models of a contract were confidential. A consultation on the commercial detail ahead of contract signature would undermine the negotiating position of government.
11. DECC believed that justifying the adoption of the non-competitive route was critical and would involve making the case for the feasibility of competition in that particular context and how this related to the overall approach to technology in the sector, both now and in the future.
12. DECC's reservations regarding remedy 2A concerned the notion that it should produce a formal Impact Assessment ahead of non-competitive CfD being signed. DECC would not necessarily have all the information available when it entered CfD negotiations and, more importantly, it could prejudice commercially confidential negotiations.

Remedy 2b – DECC to undertake and consult on a clear and thorough assessment before allocating technologies between pots and the CfD budget to the different pots

13. DECC understood the logic of the recommendation and believed it could work with it, though there were questions regarding the remedy's implementation.
14. DECC agreed it would be helpful to clarify the rationale associated with the division between pots and explain that the movement of technologies between pots was driven by technological considerations and the practicalities of ensuring effective competition.
15. DECC believed that providing the strategic context for the allocation of money to each pot and explaining the objectives was achievable, though it would be difficult to provide a precise rationale for the exact levels at which the pots were set. The size of the pots was partly driven by the strategic objectives DECC pursued, for example, the supply chains and technologies that DECC would like to see developed. The strategic decisions on the allocation of money to each pot were also driven by information DECC acquired on pipeline projects, the likelihood of these achieving effective competition and DECC's own estimates of the auctions' outcomes, and disclosure of this information would weaken the auctions significantly.
16. DECC believed that clearly setting out the logic underpinning its decision to allocate a particular technology to a given pot was achievable. This would also show which technologies DECC considered to be more mature and in need of less support and those which were less developed and needed more support.

Retail market

Remedy 3 – Remove from domestic retail energy suppliers' licences the 'simpler choices' component of the RMR rules

17. DECC saw the promotion of switching as a means to encourage customer engagement. Simplifying the decision-making process for customers regarding the most suitable tariff was one way of achieving this.
18. The Retail Market Review (RMR) was in part prompted by the perception that people were deterred from switching by the proliferation and complexity of tariffs. The limit on the number of tariffs that firms could offer was intended to address this, but the limit had been cited as hampering a firm's ability to innovate. With a number of new suppliers in the market, the number of available tariffs had increased. This had brought more complexity to choosing

a tariff, though the process was more manageable than it had been previously and technology would help in the future.

19. DECC believed it was important that the remedies clearly targeted those customers they were intended to help, enhanced their switching experience and ensured that customers felt more confident switching in the future.
20. DECC said that it was time to reconsider the four-tariff limit, but it would encourage the CMA to carefully consider the rules on tariff structure and discounts; whether there were pros and cons for these and where did they fit given the model of switching the remedies were moving towards.
21. The message that appeared on customers' bills alerting them to the cheapest tariff was an important part of the engagement process. DECC was aware of research that showed 34% of customers could recall this message, of which around 25% said they switched as a result. On-tariff discounts and other complexities could confuse this message and there was a judgement to be made as to how important on-tariff discounts were when a customer considered switching.
22. DECC recognised that customers chose tariffs for a number of reasons, such as environmental impact, the confidence gained from a price guarantee, or the ability to use innovative technology. However, it was concerned that there was a vulnerable, immobile customer base in the market, which was charged more by suppliers. For this group of customers, switching was unattractive, and might lead to poor quality service and less innovation.
23. A mechanism was required that would engage customers and respond to their changing requirements and preferences. The use of text messages to engage customers was a potential current solution, but whether this was effective and would continue to be so in the future would need to be kept under review.
24. DECC was in agreement with the provisional findings that there was no quick and obvious fix to creating a fully competitive energy market.
25. DECC suggested that the combination of smart meters, half-hourly settlement and time-of-use tariffs would lead to new entrants identifying different ways of engaging with customers and a further generation of innovation. For those 60 or 70% of customers who did not engage, there was a large risk that they would default to the proposed safeguard regulated tariff and DECC did not see how this would benefit competition.
26. DECC believed it was a judgement call as to whether a less or more regulated sector would deliver the desired level of competition. It was unclear what

would happen to the market if some of the constraints enacted in the past to promote competition were removed.

27. DECC's own work had shown that technological developments could have a positive impact on competition. The structural change of smart meters, half-hourly settlement and time-of-use tariffs could offer opportunities to firms that were creative and smart with their offerings. Removing regulatory constraints from smaller suppliers could lead to a strengthening of their position, which would gradually erode the dominant position of the established firms. In contrast, the removal of all constraints could lead to the larger firms utilising that freedom to defend their market position and reduce competition as it would be more difficult for smaller firms and new entrants to establish themselves.

Remedy 4a – Measures to address barriers to switching by domestic customers

28. DECC agreed with the CMA that smart meters would help address the issue of uncertified electricity meters and alleviate the barriers to switching for Dynamic Teleswitching (DTS) customers.
29. The CMA's proposal to enable price comparison websites (PCWs) to access the Electricity Central Online Enquiry Service (ECOES) database was a positive move. Access would enable PCWs to investigate when a switch went wrong, whereas at the moment a customer was left stranded between two suppliers, and it provided PCWs with a financial incentive to ensure the switch went smoothly. DECC believed the proposal also complemented the Secretary of State's proposal to develop a switching guarantee for the industry.
30. DECC believed that before penalties were levied for failing to switch customers in a reasonable time, it was important that the reason for the failure was identified as it might be due to factors outside the control of the energy companies. In relation to proposals to move to next day switching, DECC had explored with the industry a mechanism under which the consumer could complete the switch the next day but still have a cooling-off period to reverse their decision to switch.

Remedy 5 – Requirement that energy firms prioritise the roll-out of smart meters to domestic customers who currently have a prepayment meter

31. Remedy 5 – DECC had not prioritised the roll-out of smart meters to any specific group. It favoured suppliers being allowed to design the most efficient roll-out, which is expected to reduce costs. The new and replacement

obligation for meters meant that from mid-2018, suppliers must take all reasonable steps to install a compliant smart meter when a meter was replaced or installed for the first time.

32. DECC was aware that there were technical issues around installing the smart meters earlier than 2018, so the 2018 date was felt suitable due to issues of practicality, speed and cost.

Remedy 6 – Ofgem to provide an independent price comparison service for domestic (and microbusiness) customers

33. DECC was unsure if Ofgem was best placed to sponsor an independent price comparison service for domestic and microbusiness customers. The Secretary of State had cautioned against Ofgem becoming involved in such an undertaking and DECC suggested if another body, such as Citizens Advice, might be better placed.
34. Whatever the CMA's decision, it was important that such a comparison site increased transparency and enabled customers to obtain a fair reflection of the market in a way that was convenient for customers and facilitated switching.
35. DECC asked the CMA to consider if it was more appropriate to assess the impact of the Confidence Code on independent PCWs before proceeding with an independent comparison site. DECC noted that the microbusiness market was much more complicated and that price transparency would be needed first to allow the development of a price comparison site.

Remedy 7a – Introduction of a new requirement in the licences of retail energy suppliers to provide price lists for microbusinesses on their own websites and to make this information available to PCWs

36. A number of suppliers had claimed that it was difficult to identify those entities that were truly microbusinesses as defined by Ofgem. The inability to make this distinction led to suppliers treating all small and medium-sized enterprises (SMEs) the same. Suppliers had told DECC that an appropriate consumption-based definition of a microbusiness would be easier to use.
37. DECC agreed that energy prices for microbusinesses suffered from a lack of information. DECC was unsure as to the degree customers used a published price as a starting point for negotiations with a supplier, but if this was a strategy used by firms to reduce their energy costs, there may be a risk of publication of prices leading to firms choosing a standard tariff rather than negotiating.

38. On the whole DECC was supportive of the proposed licence condition requiring retail energy suppliers to provide price lists for microbusinesses on their own websites or via PCWs and would be supportive of suppliers developing quoting tools online.

Remedy 7b – Introduction of rules governing the information that TPIs are required to provide to microbusiness customers

39. DECC agreed that it was important for third party intermediaries (TPIs) to be clearer and upfront about the type and the costs of the service that they were offering to microbusinesses.
40. On the question raised on full licensing of TPIs, DECC believed it would be appropriate to see how Ofgem's work on a code of practice for non-domestic, third party intermediaries developed before deciding on full licensing. DECC asked the CMA to consider if full licensing, and the constraints this implied for the non-domestic sector, was consistent with a reduction of the regulatory constraints on the domestic sector.

Remedy 8 – Introduction of a new requirement into the licences of retail energy suppliers that prohibits the inclusion of terms that permit the auto-rollover of microbusiness customers on to new contracts with a narrow window for switching supplier and/or tariff

41. DECC agreed that auto-rollovers reduced the window for customer engagement and tended to reduce competition. There was a risk that customers could be moved onto more expensive variable or fixed contract rates, and DECC asked whether additional prompts or protection were needed for microbusinesses prior to their contracts finishing.
42. DECC would support an industry-wide ban on auto roll-overs.
43. DECC also hoped that the CMA could develop a better understanding about the different types of consumer and the similarities and differences between microbusinesses and different types of households.

Remedy 9 – Measures to provide either domestic and/or microbusiness customers with different or additional information to reduce actual or perceived barriers to accessing and assessing information

44. DECC said that that it had a detailed evaluation of the effectiveness of its Big Energy Saving Network which funded third parties to hold events and speak individually to vulnerable consumers. However, it had proved more difficult to track and identify the end results of many of the switching campaigns it ran. It

cautioned that any information remedy that the CMA proposed should be subject to extensive testing.

Remedy 10 – Measures to prompt customers on default tariffs to engage in the market

45. DECC suggested that allowing rival companies to contact customers who had been with a supplier for a certain number of years was one way of offering suppliers another route into the market. However, it was important to avoid a situation where customers were bombarded with phone calls and marketing material.

Remedy 11 – A transitional ‘safeguard regulated tariff’ for disengaged domestic and microbusiness customers

46. DECC relayed to the panel that ministers were interested in the safeguard tariff remedy. DECC understood why it had been proposed and that it was important to consider how best to protect disengaged consumers. On proportionality, DECC suggested that the safeguard tariff may not be compatible with some of the competition aims and objectives pursued by the CMA. DECC recognised that no matter how successful the pro-competition remedies were, it was likely that a considerable section of consumers would remain disengaged from the energy sector. This was a very important issue that needed to be addressed, but DECC felt that the safeguard tariff could entrench disengagement if people felt that the safeguard tariff was approved by the regulator and once on it they would be less inclined to switch.
47. DECC cited a number of risks that could follow from a safeguard tariff including:
- entrenching disengagement, leading to a higher percentage of sticky customers; and
 - a narrowing of the benefits of switching from the default and safeguard tariffs to potential discount tariffs.
48. DECC agreed there were economic arguments for a safeguard tariff. Limiting the revenue a supplier generated from its standard variable tariff (SVT) would decrease the supplier’s ability to cross-subsidise switching customers. A supplier would either have to accept a lower level of profitability or not spend so much on subsidising those customers that switched. DECC considered this could make the market more attractive for new entrants, with increased competition and a better service for customers.

49. DECC said that there were practical issues around the setting of the tariff, particularly as to how would a regulator respond if wholesale prices rose. In this respect, it was important that a safeguard tariff did not introduce too much rigidity into the market and make it difficult for a regulator to make robust judgements when responding to wholesale price changes.
50. DECC suggested it was worth considering whether it would be possible to target the remedy in such a way that it favoured vulnerable customers or those who were inherited by a supplier.
51. DECC had considered how the default tariff could be targeted at a smaller group of vulnerable customers, rather than all SVT customers, possibly by taking into consideration certain demographic characteristics. When it defined vulnerability, DECC did not look at any particular group but, instead, focused on the interaction of customers at particular points in the market and the barriers they faced.
52. DECC was unsure if a smaller group of vulnerable customers could be identified with sufficient confidence and noted that it might be difficult for suppliers to identify these groups. DECC had used proxies such as the Warm Home Discount, but such measures might not capture all vulnerable customers.
53. DECC thought it was a sensible idea that there would be an interim period before the tariff was introduced, where suppliers would have the opportunity to persuade customers to switch away from their SVT, either through internal switching or moving to another supplier. The proposal would be heavily marketed and could accelerate the use of the engagement mechanisms that would help switching in the longer term.
54. DECC suggested that rather than searching for a certain market dynamic or target which would trigger the end of the safeguard tariff, if reliable one-day switching, smart meters and Midata, which were intended to remove barriers to switching, had not prompted a person to switch, perhaps it was more clearly a personal choice than was previously the case. At this stage, regulatory intervention might carry less weight.
55. If the safeguard tariff were to be a cost-based tariff, that reflected wholesale, network and social and environmental costs, then wholesale prices appeared to be the most difficult item on which to form a view. DECC had engaged in a long debate with suppliers regarding social and environmental costs, and heard their concerns with regards to how difficult these were to measure.
56. If the CMA intended the tariff price to include significant headroom, then issues around information asymmetry were probably less important and it

would be more straightforward to construct a cost-based tariff, but the uncertainty around wholesale, network and social and environmental costs could still lead the robustness of the decision-making process, and the price that was decided, to be challenged.

57. DECC noted that in other regulated markets, costs were stated at a higher level than might otherwise have been the case, which led to a higher price for consumers.
58. Wholesale costs would need to be based on a market estimate. This could mean that suppliers would adjust their hedging policies to match the duration of the tariff. DECC said that while the economics of how SVTs functioned were difficult to understand, on the policy side, ministers placed weight on certainty, and in particular on consumers knowing what their bills were likely to be. While insurance and hedging increased expected costs, it reduced the volatility of outcomes, around retail prices.

Remedy 12a – Requirement to implement Project Nexus in a timely manner

59. Remedy 12A – DECC said that while Project Nexus was a significant IT programme for firms to implement, it believed things were moving in the right direction, and at the right speed now, and DECC had encouraged them to do so.

Remedy 12b – Introduction of a new licence condition on gas shippers to make monthly submissions of Annual Quantity updates mandatory

60. DECC agreed with the CMA that reform of the gas system was necessary, but it had some practical concerns regarding the monthly updates. To meet this obligation, consumers' meters would need to be read constantly and DECC's understanding was that Project Nexus, combined with smart meters, would facilitate more efficient readings, allowing recalculations to be done on a rolling basis.

Remedy 13—Requirement that domestic and SME electricity suppliers and relevant network firms agree a binding plan for the introduction of a cost-effective option to use half-hourly consumption data in the settlement of domestic electricity meters

61. DECC was very supportive of half-hourly settlement and wanted this adopted as soon as was possible. DECC had undertaken preparatory work on proposals to give Ofgem increased powers to develop settlement more quickly, which would also feed into code governance, and hoped to publish these before Christmas 2015.

62. Suppliers had told the CMA that half-hourly settlement was another large IT project they would have to take on. DECC was aware that there were a number of major projects and it was trying to understand the totality and sequencing of these, to determine what was doable and which were sensible.

Remedy 1 – Introduction of a new standard condition to electricity generators’, suppliers’, interconnectors’, transmission, and distribution licences to require that variable transmission losses are priced on the basis of location in order to achieve technical efficiency

63. DECC agreed that locational pricing would provide economic benefits, greater efficiency and a greater reflection of the whole system impacts of generators. When finalising the proposals, DECC said that it was important that decisions were based on up-to-date evidence and analysis, and were robust to withstand legal challenges from the affected generators.

Remedy 15 – More effective assessment of trade-offs between policy objectives and communication of impact of policies on prices and bills

64. DECC supported greater transparency in the regulatory decision-making process, but did not believe that a further body, in addition to DECC and Ofgem, was needed. DECC believed that it was more important to ensure that the existing arrangements worked well.

Remedy 17 – Introduction of a formal mechanism through which disagreements between DECC and Ofgem over policy decision-making can be addressed transparently

65. DECC and Ofgem had common areas of working as Ofgem relied on DECC to pass legislation to progress Ofgem’s own work. DECC and Ofgem also looked at different facets of the same problem and their interests were aligned. The previous government had hoped to increase transparency through the Strategy and Policy Statement, which set out the broad policy considerations to which Ofgem would have regard. DECC had not completed the statement by the time of the 2015 election, but hoped to do so in the future. It was hoped the statement would clarify DECC’s and Ofgem’s shared agenda.
66. DECC was not in favour of more formal direction powers for DECC in respect of Ofgem. In DECC’s opinion, this would negate the impact of having an independent regulator that made independent decisions, a process that was protected under European law.

67. DECC was keen to ensure that its relationship with Ofgem was viewed as fair and equitable. Ofgem could independently express its views, but DECC and Ofgem did meet to discuss future events and coordinate their approach. DECC did not see a great need for a more formal reiteration of its relationship with Ofgem, for example, via a memorandum of understanding, and would be sceptical about such a formal power of direction. More workable was an open-letter type of transparency model, particularly regarding legislation.
68. With regard to the capacity market auctions, while decisions were taken by ministers and the Secretary of State, the process was reliant on information provided by Ofgem. DECC believed that this arrangement may well evolve with further auctions, identifying the appropriate roles for each organisation.
69. DECC clarified how consumers' bills were made up through its prices and bills report. Explaining the different components of a bill was a complicated area as comments from DECC could lead to changes in consumption and unit prices. The presentation of such information was also something that the new government would want to consider.
70. DECC was unsure how effective an external, independent body would be in explaining the trade-offs and relationship between DECC and Ofgem. DECC did not believe that a body based on the Office for Budget Responsibility (OBR), as had been proposed in some quarters, would work in energy. The OBR dealt with fairly technical questions, whereas energy policy involved a number of judgement calls about, for example, tax policy and different consumer groups. DECC did not believe an independent body could reconcile these issues and be accepted as authoritative.

Remedy 16 – Revision of Ofgem's statutory objectives and duties in order to increase its ability to promote effective competition

71. Ofgem's legal remit had changed since 2010. Prior to this date, Ofgem's focus was, 'where appropriate', to promote competition, but post-2010, Ofgem's policy considerations included examining factors alongside competition.
72. Pre-2010, DECC believed that Ofgem focused on competition without enough due regard to what was meant by 'where appropriate'. If Ofgem's remit was amended so that there was a stronger focus on competition, it was important that Ofgem took into consideration other issues that consumers cared about, such as security of supply and mis-selling.

Remedy 14 – Remedy to improve the current regulatory framework for financial reporting

73. DECC believed that it was important to have consistent financial data. It asked the CMA to consider the benefits of the proposed remedy versus the cost of compliance, and the extent of financial data required. DECC recognised that there was a judgement to be made regarding the balance between the costs and benefits.
74. DECC said that ministers were interested in whether there was a case for extending the EU requirements (REMIT) to reporting internal trading, which may address the transparency issue.

Remedy 18a – Recommendation to DECC to make code administration and/or implementation of code changes a licensable activity

75. DECC recognised that the complexity of the current system of code governance favoured incumbents over new entrants to the detriment of both new entrants and consumers. The codes were very technical and the technical knowledge resided with the incumbents.
76. DECC asked the CMA to consider the most effective way in which to enact any changes. Legislation and consultations could take time and non-regulatory measures should be considered. There was also a relationship between the codes and other measures designed to improve the energy market and a programme to reform code governance could negatively impact on other elements such as the introduction of smart meters.
77. DECC believed there were a number of actions that would not require further regulation of the industry that could meet the CMA's aims, such as aligning code objectives and ensuring that all codes had urgent and fast-track modification provisions.

Remedy 18b – Granting Ofgem more powers to project-manage and/or control timetable of the process of developing and/or implementing code changes

78. DECC believed that Ofgem could have a role to play in ensuring that the timetables for code changes were met, but DECC still wanted the energy industry to have a major role in the development of code changes in order to ensure that the process benefited from the industry's expertise and was robust.

Remedy 18c – Appointment of an independent code adjudicator to determine which code changes should be adopted in the case of dispute

79. If Ofgem was given more powers under Remedy 18B with regard to code changes, DECC wondered if an independent code adjudicator would really be necessary.

Remedies the CMA is not minded to pursue

Remedy c – Opt-out collective switching of disengaged customers

DECC noted that the remedy could, potentially, target directly those in the energy market who currently did not engage. Given the challenges that DECC had outlined regarding the safeguard tariff, it queried whether the practical difficulties of the collective opt-out switch could be mitigated.

Remedy f – A transitional safeguard regulated price structure

80. DECC was unsure if this remedy would influence consumers' engagement with the market, but it believed it may frame competition in a way that linked it to the services offered by suppliers, rather than companies competing on margins.