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Consultation on a proposal to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain

Consultation

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Overview:

This document sets out Ofgem's proposal to make a market investigation reference to the Competition and Markets Authority. We welcome views on this consultation.

Context

In November 2013 Ofgem agreed to work with the Office of Fair Trading (OFT) and the Competition and Markets Authority (CMA) to produce an assessment of competition in the retail market. The Assessment, which has been published today, updates previous work that Ofgem has undertaken including the Retail Market Review and the Energy Supply Probe.

This document seeks views on Ofgem's proposed decision to make a market investigation reference to the CMA.

Associated documents

Letter from the OFT, Ofgem and CMA to the Secretary of State for Energy and Climate Change

https://www.ofgem.gov.uk/ofgem-publications/84642/ofgemoftandcmatosecretaryofstatecompetitioninenergymarkets.pdf

State of the market report – Assessment framework – 19 December 2013

https://www.ofgem.gov.uk/ofgem-publications/85260/assessmentframework18decfinal.pdf

State of the Market Assessment document – 27 March 2014

https://www.ofgem.gov.uk/publications-and-updates/state-market-assessment

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Executive Summary

Ofgem has previously set out its concerns about competition in the energy market, and has put in place remedies to address the most pressing problems we found. We have just completed a joint study with the OFT and CMA ("the Assessment") which raises similar concerns about the state of competition as well as providing further evidence that some of the problems may have worsened in recent years. The Assessment was carried out by all three organisations and gathered considerable evidence, including discussions with a wide range of stakeholders, many of whom expressed the view that enduring problems remained with competition in the market.

As a result of the Assessment and the persistence of the problems with competition, as well as the further evidence gathered, Ofgem is now proposing to make a market investigation reference to the CMA. The aim of the reference would be to establish if there are market features which are having an adverse effect on competition and, if so, whether there are reforms, including those outside Ofgem's powers, which would make competition in the market more effective.

Ofgem believes the legal test required to make a market investigation reference (MIR) has been passed. Where this threshold is met, Ofgem has discretion as to whether or not to make a reference. We now set out the main areas of concern:

Weak customer response

There is evidence that customer switching has been falling over recent years despite increasing prices and significant savings available for consumers that change supplier. There was a significant spike in switching in late 2013 but it is not clear whether this trend will be sustained, and we note that the switching rate has materially decreased in January 2014. Crucially, consumer trust has fallen significantly in recent years with the last survey showing that 43 per cent of consumers did not trust energy suppliers, an increase of 4 percentage points from the previous year.

This low level of consumer engagement is the result of a variety of factors including the intrinsic nature of the product, poor information from suppliers and the long switching times. Coupled with the low level of consumer trust in the market this leads to a weak customer response which is not compatible with a state of healthy competition which would require active and confident consumers.

Continued evidence of incumbency advantages

Previous analysis suggested that incumbent energy suppliers in both electricity and gas all have a relatively high proportion of customers who never or rarely engage in the market. These suppliers are able to charge higher prices to these "sticky" customers whilst making cheaper deals available to more active customers. Whilst incumbent market shares have fallen slightly, the Assessment has shown that this ability of incumbents to exercise market power is still present and is not compatible with an effectively competitive market.

Further evidence of possible tacit coordination

Previous analysis showed evidence of weak competition in the market due to aligned pricing strategies of the six larger suppliers. Ofgem would stress that it found no evidence of explicit collusion between these suppliers. But tacit coordination can have the effect of reducing competition between suppliers and worsening outcomes for consumers.

The Assessment has found further evidence of possible tacit coordination and indeed that this pattern of behaviour may have become more entrenched over recent years. It has found evidence of strong alignment of pricing announcements, in both timing and extent, as well as a pattern of suppliers raising prices more rapidly and to a greater extent in response to an increase in costs than they reduce prices in response to a fall in costs. This is a sign of a lack of competition.

Vertical integration and barriers to entry

Many stakeholders highlighted barriers to entry and, particularly, expansion in energy markets. These include low wholesale market liquidity, credit and collateral requirements, suppliers' pricing strategies, regulatory barriers and reputational risks While there has been recent growth in new entrants who now have a 5 per cent market share, there is no evidence of sustained expansion at a scale which would provide a disruptive competitive threat.

The structure of the six larger suppliers is characterised by a high degree of vertical integration (VI) between generation and supply. VI can bring benefits in terms of reduced risks and costs but can also risk increasing barriers to entry for non-integrated suppliers who may not be able to obtain the wholesale products they need to compete. VI could also weaken competition between existing suppliers as they look to maintain a balance between their generation and supply businesses.

The Assessment did not conduct a full analysis of the costs and benefits of VI. But it has raised sufficient concerns that the model may be limiting competition as to merit a fuller study.

Increased supplier profits

There has been evidence of increasing average profitability in the six larger suppliers over the last four years. The Assessment has not come to a conclusion as to whether excess profits are being made but notes the recent increases and questions the suppliers' contentions that five per cent is a fair margin. It also notes that there is variation in profitability amongst the large suppliers, and that there has been no clear evidence of efficiency improvements that might be expected in a strongly competitive environment. While the evidence of profitability is not conclusive, the rise over the last few years allied to no clear evidence of increasing efficiency is indicative of a possible lack of effective competition.

Conclusion on competition

Taken together, these problems indicate a lack of effective competition in energy markets. The problems identified have been analysed in previous Ofgem reviews but have persisted, and in some cases worsened, over the last few years. They constitute clear evidence that consumers are not being well served by current levels of competition.

Proposed MIR

Ofgem has put in place a number of remedies to improve competition in the market. These include the RMR which is designed to make the market simpler, clearer and fairer for consumers to engage in. Ofgem has also put in place reforms to increase liquidity which will help independent suppliers to access the wholesale products they need. We are confident that these should improve competition in the market. However there continue to be low levels of consumer trust and public concern over the sector, which may limit the ability of RMR to deliver increased consumer engagement at the pace that is needed. There is also continuing uncertainty over whether vertical integration is in consumers' interests. The CMA would be well placed to analyse all of these issues using its experience to draw on evidence from other sectors and given the broader powers it can draw on should it conclude structural change is needed. A comprehensive review of these complex and inter-related issues should help restore consumer confidence in the working of the market.

Given the high levels of public concern about energy costs we consider that it is right to set this process in train now so that if further changes are needed consumers can benefit at the earliest opportunity. Leaving open the possibility of a reference while we wait to see what the effect of our reforms is would also have potentially negative impacts on investment and delay the conclusion of that period of uncertainty.

The energy sector is on the cusp of major change with the rollout of smart metering, the proposed introduction of Electricity Market Reform and the move to an integrated European-wide market. We would expect the CMA, in considering any reference, to take account of these reforms.

We would also expect the CMA to focus on ensuring that the market works for all consumers, including vulnerable consumers for whom the high level of prices are a particular concern.

In the meantime we will continue with the range of regulatory projects that we have in hand aimed at improving competition and maintaining security of supply. This would allow us to make timely changes to protect consumers' interests in parallel, with any CMA investigation.

1. Introduction

Chapter Summary

In November 2013 Ofgem agreed to work with OFT and CMA to produce an assessment of competition in the retail market.

The Assessment, which has been published today, updates previous work that Ofgem has undertaken.

This document seeks views on Ofgem's proposed decision to make an MIR.

The joint Market Assessment

1.1. At a time when consumers are faced with rising energy prices and many are struggling to pay their bills there are inevitably questions about how effectively the energy market is working. Ofgem has previously made clear that in its view the market is not working as well as it should. We have recently introduced reforms under our Retail Market Review (RMR) aimed at making the market simpler, clearer and fairer for consumers. We have also just introduced new rules – our liquidity reforms – aimed at making it easier for independent suppliers and generators to access and compete in the wholesale market.

1.2. As part of its RMR reforms, Ofgem had committed to monitor the impact of its proposals and report regularly in its assessment of competition and the health of the market. In our response to the Energy and Climate Change Committee we committed to producing this assessment annually. The Secretary of State subsequently asked Ofgem to work with the Office of Fair Trading (OFT) and the Competition and Markets Authority (CMA) to deliver the first assessment by the end of March 2014.

1.3. By bringing together Ofgem's knowledge of energy markets with the OFT's wider experience of market assessments we have produced a joint assessment that provides an updated view on the effectiveness of competition in the market and identifies key areas of continuing concern.

1.4. The Assessment published alongside this consultation includes new analysis in a number of areas and involved interviews with over 40 stakeholders, including a range of small suppliers and potential new entrants. It looks at both the domestic and the small business market while recognising that in general past analysis has suggested greater competition and fewer problems for consumers in the small business market.

Previous Ofgem studies

The Energy Supply Probe

1.5. The Energy Supply Probe ('the Probe') was launched in 2008 prompted by a range of consumer concerns including a very sharp increase in retail prices linked to rising global energy prices. It looked at a range of areas including consumers' experience of the market; switching rates and suppliers' pricing of different market segments; the relationship between retail and wholesale energy prices; suppliers' market shares; liquidity and entry into the market. Based on this evidence Ofgem put in place a number of remedies, including launching a fuller review around liquidity in the wholesale market.

The Retail Market Review

1.6. Following the Probe, Ofgem's regular monitoring of the retail market raised concerns that some areas of the market were still not working effectively. The RMR was therefore launched to establish suppliers' progress in implementing the Probe reforms and whether further actions were necessary to address any remaining issues. The review found that while there had been improvements in certain areas since the Probe, many of the problems with consumer engagement remained and there was evidence of persistent consumer harm. We also found that many practices were not in line with the spirit, and in some cases the letter, of the new rules implemented through the Probe. As a part of this review Ofgem undertook extensive consumer research to help build its understanding of the potential causes of the low levels of consumer engagement. A number of remedies were put in place to seek to tackle the low levels of consumer engagement and trust.

Liquidity

1.7. In 2011 Ofgem published an assessment of wholesale market liquidity building on its earlier work in the Probe. This identified only limited improvements in the availability of wholesale products that new entrants need in terms of high volumes of standard products (as measured by churn and bid-offer spreads); availability of longer dated products (13 months and beyond) and meeting the needs of independents for specific products (in terms of shape and size).

1.8. In November 2013 we concluded that we had consistently found that GB wholesale electricity market liquidity was poor, particularly for products traded ahead of when they will be supplied. We found that this was inhibiting the ability of market participants – particularly independent market participants - to compete effectively in the electricity generation and supply markets. Reforms have been introduced which will take effect from 31 March 2014.

The Market Investigation Reference regime

1.9. Under s.131 of the Enterprise Act 2002[1], Ofgem has the power to make a Market Investigation Reference (MIR) to the Competition Commission (the CMA from 1 April 2014) where it has reasonable grounds for suspecting that any feature or combination of features of a market in the UK for goods or services, prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or part of the UK. Where this reference test is met Ofgem has discretion as to whether to make a reference.

Structure of this document

1.10. This document sets out the basis for Ofgem's proposed decision to make an MIR, and seeks views from stakeholders. The structure of the document is summarised below:

Chapter 2 – The legal framework. We set out the legal test for Ofgem to make a market investigation reference to the CMA.

Chapter 3 – The features of the market which prevent, restrict or distort competition. We set out our views on the features we have identified through previous Ofgem work, and the Assessment published alongside this consultation document. On the basis of this analysis we conclude that the reference test is met.

Chapter 4 – The impact of Ofgem's regulatory actions and wider policy developments. In deciding whether to exercise our discretion to make a reference a key consideration is the extent to which the reforms that we have already put in place could be expected to address the features identified. We therefore summarise the work that Ofgem has completed, the reforms we have put in place and the work that we will continue with. We consider the impact of these reforms on the features that we have identified.

Chapter 5 – Exercising our discretion to propose a reference. We outline the issues that we have considered in deciding whether to exercise our discretion to propose a reference. On the basis of this analysis we conclude that a reference at this stage would be in consumers' interests.

[1] Section 36A of the Gas Act 1986 and section 43 of the Electricity Act 1989 provide that Ofgem has concurrent jurisdiction with the OFT/CMA in respect of commercial activities in the energy sector.

Next steps and timetable

1.11. We welcome views on our consultation on the proposal to make a market investigation reference to the CMA, by 5pm on **Friday 23 May 2014**. Responses to this consultation should be sent to by stateofthemarket@ofgem.gov.uk. We will then consider these responses and then aim to publish our decision in the summer.

1.12. If Ofgem decide to make a MIR to the CMA after considering consultation responses, then we will publish a decision letter confirming the features that we had grounds to suspect were causing an adverse effect on competition together with the reasons for us to exercise our discretion. The reference would then be made to the CMA and would require them to complete a market investigation.

1.13. While the focus of the Assessment has been on the energy supply market, if we decide to make a MIR we will need to set out in the reference the market that we are referring. Our aim would be to cast the reference broadly to allow the CMA to explore the full range of potential features, including vertical integration. A draft of the proposed reference is included in Appendix 2.

1.14. Guidance on the CMA's MIR process is available on their website. Their standard timescale for completion of an MIR is 18 months for the reference, plus a further six months for implementation of remedies.

2. Legal framework

The reference test

2.1. In order to be able to make a MIR, Ofgem must have reasonable grounds for suspecting that any feature, or combination of features, of a market in the United Kingdom for goods or services prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the United Kingdom or a part of the United Kingdom (the 'reference test').[2]

2.2. If this threshold is met then Ofgem is able to make a reference but has then to consider whether to exercise its discretion to do so. The reference test sets out three types of market feature that could have an adverse effect on competition: structural features, conduct of firms, and the conduct of customers.[3] There will often not be clear separation between structural features and those relating to conduct but our view is that all three types of features are present in the market we are proposing to refer to the CMA for further investigation.

2.3. Ofgem's principal objective is to protect the interests of existing and future energy consumers. These interests are to be taken as a whole and include the reduction of greenhouse gases, the security of the supply of gas and electricity to consumers, and Ofgem's fulfilment of the objectives in the EU Gas and Electricity Directives (such as the promotion of competition, helping to ensure consumer protection and contributing to the protection of vulnerable consumers). When exercising regulatory functions Ofgem is generally required to act in the manner it considers will best further the principal objective, by promoting effective competition in the activities where appropriate. However, before performing regulatory functions with a view to promoting competition, Ofgem must always first consider the extent to which the interests of consumers would be protected by the promotion of competition and whether there are other ways which would better protect these interests.

2.4. In deciding whether to exercise its discretion to make a reference Ofgem therefore has to decide whether such a reference would be in consumers' interests.

2.5. Ofgem would also have regard to the OFT guidance on when an MIR would be appropriate which includes consideration of the extent to which the features

[2] S.131(1) of the Enterprise Act 2002
[3] S.131(2) of the Enterprise Act 2002

identified can be expected to persist and whether other action would be more appropriate.

2.6. The OFT and Ofgem have concurrent powers to make MIRs under part 4 of the Enterprise Act. In accordance with statutory requirements[4], Ofgem has consulted with the OFT on its intention to exercise concurrent powers and has confirmed with OFT that in this instance it is appropriate for Ofgem as the sector regulator to exercise such powers.

2.7. Under section 169 of the Enterprise Act, when Ofgem is considering whether to make a decision on a reference it must first consult, so far as reasonably practicable, any person on whose interests the decision is likely to have a substantial impact. This document sets out for consultation the reasons for Ofgem's proposed decisions and invites views.

The MIR process

2.8. If, following consultation, Ofgem decides to make an MIR then the CMA would be required to investigate whether there are any features of the market that prevent, restrict or distort competition ('adverse effects on competition').

2.9. If the CMA decides that there are one or more adverse effects on competition it must take such action as it considers reasonable and practicable to 'remedy, mitigate or prevent' the adverse effect on competition and to 'remedy, mitigate or prevent any detrimental effects on customers' so far as those effects have resulted from the adverse effect (section 138 of the Act).

2.10. In order to achieve that, the CMA may accept undertakings from appropriate persons or may make an Order under section 161 of the Act. Such an Order may contain anything permitted under Schedule 8 of the Act, as well as supplemental provisions. Schedule 8 provides the CMA with wide-ranging powers falling within the following general areas: power to order non-price information to be provided without also requiring price information, general restrictions on conduct, general obligations to be performed, acquisitions and divisions, and the supply and publication of information.

2.11. The CMA may also modify the conditions of licences granted under sections 7, 7A and 7B of the Gas Act 1986 and section 6 of the Electricity Act 1989. When deciding whether such action would be reasonable and practicable for the purpose of

[4] Section 36A(5) of the Gas Act 1986 and section 43(4) of the Electricity Act 1989.

remedying, mitigating or preventing an adverse effect on competition, the CMA would be obliged to have regard to Ofgem's principal objective and general statutory duties.

3. Features of the market which prevent, restrict or distort competition

Chapter Summary

The Assessment identifies a number of features of the market that are mutually reinforcing and that together would appear to be having an adverse effect on competition.

These features include weak customer response, vertical integration and wider barriers to entry and expansion, continuing incumbency advantage and evidence of possible tacit coordination.

These features lead to poor outcomes for consumers with concerns about rising profits. Consumer trust is at an all-time low.

These features reflect what Ofgem has observed in previous reviews of the market and the persistence, and in some cases worsening, of these features is a particular concern.

On the basis of this evidence Ofgem is satisfied that the test for it to able to make a Market Investigation Reference is met.

The Market Assessment

3.1. As set out above, building on the findings of the Probe and the RMR, Ofgem has been working with the OFT and CMA to provide an updated view of the state of the market. As set out in the Framework document published in December 2013[5] we did this by following the standard Competition Commission approach of identifying potential theories of harm.

3.2. The full findings are set out in the Assessment but we summarise below the particular features that Ofgem has reasonable grounds to suspect may be preventing, restricting or distorting competition. These are the principal features that we have identified based on the Assessment and our previous reviews. In the event of a Market Investigation Reference (MIR) it remains open to the CMA to form its

[5] https://www.ofgem.gov.uk/ofgem-publications/85260/assessmentframework18decfinal.pdf

own view on the market features which would be investigated within the scope of any reference made.

3.3. The features we have identified are:

- weak customer response;
- vertical integration and wider barriers to entry and expansion;
- continuing incumbency advantage and market segmentation; and
- further evidence of possible tacit coordination.

3.4. We then look at the outcomes for consumers in particular in terms of increasing profits.

3.5. The scope of the Assessment was domestic and small non-domestic consumers. The Assessment has focussed on the domestic market but we set out below where we consider the position is different for small non-domestic consumers. We recognise that while we have found more effective competition and better outcomes in the non-domestic market, smaller non-domestic consumers face many of the same features as domestic consumers.

Weak customer response

3.6. In competitive markets we would expect to see consumer actions, such as the threat of switching supplier, exert competitive pressure on suppliers. However, as the Assessment shows, there appears to be large parts of the market where this is not occurring.

3.7. As Ofgem has previously observed, energy as a product has low intrinsic interest for consumers - it is consumed indirectly through the provision of heat, light, cooking etc. Consumers typically have low awareness of their energy consumption although there are high levels of concerns about the levels of bills and affordability of what is an essential service. For most customers on evergreen contracts there is no obvious trigger or decision point to prompt engagement.

3.8. The Assessment notes the evidence from RMR in 2011 that at that time:

- There were a large number of tariffs, many of which had complex structures and discount arrangements. This made the prospect of engaging in the market unattractive for many consumers and meant it was often difficult for consumers who did engage to choose the best deal for them.

- There were gaps and lack of clarity in the information given by suppliers to consumers which meant that they were not prompted to engage or given the full set of information they needed to assess options in the market.

- There was a lack of trust and poor supplier conduct which further reduced the confidence of some customers to engage in the market and contributed to the permanent disengagement of others.

3.9. The Assessment also notes the updated research carried out by Ofgem last year[6]. This showed that barriers to accessing and identifying best offers remained, ahead of the RMR reforms being introduced. 62 per cent of consumers said there were too many tariffs available with 54 per cent saying they understood the range of tariffs 'not very much' or 'not at all'.

3.10. The Assessment also notes the impact that concerns about the switching process and the long timescales for switching can have on consumers' readiness to engage in the market. The relatively high level of savings that customers say they would need to make to switch is likely to be an indication of the perceived risks in switching. Of those who had switched 26 per cent said they wouldn't do so again because of the time involved and disappointment at the outcome.

3.11. Overall satisfaction and trust in suppliers is low and has continued to fall. 43 per cent of domestic customers distrust energy companies to be open and transparent in their dealings with consumers. [7]

3.12. The Assessment considers the switching rate to be an indicator of the extent of competition in a market. Switching rates have fallen year on year since 2008, despite persistent price differentials and potentially large savings from switching. This may be explained, at least in part, by the gradual withdrawal from doorstep selling by the six largest suppliers. There was a spike in switching at the end of last year which saw the highest monthly switching rate for at least five years. We think this is due to extensive publicity and media interest surrounding the recent price rises. It is not clear whether these trends will be sustained, and we note that the switching rate has materially decreased in January 2014.

3.13. The Assessment also notes that a large number of domestic consumers don’t switch, or switch very rarely. In Ofgem research 62 per cent of domestic consumers could not recall switching supplier.

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[6] Ipsos MORI, Customer Engagement with the Energy Market - Tracking Survey 2013, p40-42
[7] Ipsos MORI, Customer Engagement with the Energy Market - Tracking Survey 2013, p.52

3.14. In conclusion Ofgem's view is that weak customer response is a feature of the market that is having an adverse effect on competition, and that has become more pronounced in recent years.

Vertical integration

3.15. Vertical integration is a feature of the electricity market with the six largest suppliers all vertically integrated. Overall the six largest suppliers directly own about 70 per cent of generation capacity. All of the six largest suppliers, except British Gas, would have the capacity to self-supply for their domestic customer base. Low liquidity in the electricity wholesale market creates potential barriers to entry and expansion in terms of the ability of independent suppliers to get the wholesale products they need to compete.

3.16. Although there has been a recent increase in the level of penetration of independent suppliers which is now at over 5 per cent, the largest independent supplier remains at under 2 per cent. There is no evidence of sustained expansion which would provide a disruptive competitive threat.

3.17. Vertical integration is not such a strong feature of the gas market. The GB market for gas supply is well connected with other markets through import pipelines and LNG import terminals. These links make the GB market part of a wider international market for gas.

3.18. Vertical integration provides a financial hedge against volatile wholesale energy prices and a natural hedge against balancing risk. As well as having less of a requirement to trade, integrated suppliers are also likely to have stronger credit ratings, allowing them to provide lower levels of collateral. Without these benefits, non-integrated suppliers need to provide significant collateral in order to trade in wholesale markets. It is also likely that vertical integration reduces the cost of capital relative to similar non-integrated businesses, because it reduces exposure to volatile market risk. As power generation is capital intensive, this could yield a significant benefit to consumers through lower prices and security of supply.

3.19. All of the large electricity suppliers arrange their supply chains in an integrated structure and some smaller suppliers have sought to put in place long term supply arrangements. This implies that there are real benefits to vertical integration, which should be passed through to consumers in a competitive market.

3.20. Generators considering investment in new capacity are likely to need to be confident, given the long term nature of the investment, that they have a market for their output. Being vertically integrated may provide this and could reduce the investment risks for generators, potentially delivering benefits in terms of security of supply.

3.21. However as set out in the Assessment, vertical integration also has potential costs in terms of reduced competition in energy markets. This manifests itself through low liquidity, barriers to entry and expansion, and weaker incentives to compete.

3.22. As set out in our work on liquidity this is a particular issue in terms of the types of products offered and how far ahead they are available. A lack of robust reference prices in the market can also make it harder for small suppliers to secure long term contracts. A lack of liquidity in the market for longer-term contracts may also inhibit the ability of independent generators to secure finance for new investment, and may raise their cost of capital.

3.23. The longer term profitability analysis carried out for the Probe and the RMR, and reflected in the Assessment, highlights how over the last decade retail margins have declined when wholesale prices increased, and vice versa. Overall profits have been more stable over time than either generation or supply, possibly demonstrating the value of a natural hedge.

3.24. Ofgem also suspects that vertical integration may be contributing to weak competition between existing suppliers, as they look to maintain a matched position, at least for their domestic and SME customer base. Given the benefits noted above in terms of cost efficiencies for suppliers there would be an economic incentive for them to look to operate on this basis and our review of business plans for the Probe identified that targets for consumer numbers were often set on this basis. The relatively stable market shares of the six largest suppliers over time and the fact that EDF as the only 'long' supplier is currently offering the cheapest tariffs as a means to grow its retail business provides further evidence to support this hypothesis.

3.25. In conclusion Ofgem recognises that vertical integration brings benefits by reducing costs and risks in both power generation and retail. This should ultimately benefit customers through lower prices and improved security of supply. However there may also be costs to consumers through creating barriers to entry and expansion, and potentially weaker incentives to compete. The impact of barriers to entry linked to vertical integration are particularly significant in a market where competition is already weak. Ofgem therefore has reasonable grounds for suspecting that vertical integration is a feature of the market which has an adverse effect on competition. However, we recognise that, if we decide to make an MIR it will be important for the CMA to weigh up carefully the costs and benefits of vertical integration.

Wider barriers to entry and expansion

3.26. In terms of wider barriers to entry and expansion, the small suppliers and potential new entrants that we spoke to as part of the Assessment raised a wide range of other factors which largely confirmed the barriers that Ofgem had identified in the Probe. Some small suppliers have told us that credit and collateral requirements associated with being a supply company act as a barrier to expansion.[8]

3.27. Credit and collateral costs were highlighted as an issue by most small suppliers. The collateral required to trade on wholesale markets is noted above, but there are also credit and collateral requirements set out in industry codes and further requirements anticipated as part of DECC's Electricity Market Reforms. This acts as a barrier as suppliers need a strong credit rating or access to working capital finance in order to enter or expand their operations.

3.28. Stakeholders said that the low levels of consumer engagement and ability of larger suppliers to target cheaper tariffs towards the most active consumers in the market (as described below) make it more difficult for small suppliers to win market share.

3.29. Reflecting the essential nature of the service and public policy goals around decarbonisation and security of supply the energy market is heavily regulated. As well as licence conditions there are a number of industry codes (aimed at ensuring the end-to-end system works) subject to industry governance processes. While this regulatory environment may be seen as a 'cost of doing business' applicable to all suppliers, the complexity and costs of compliance are more burdensome for smaller suppliers, who have smaller customer bases over which to spread these costs. Similarly, smaller suppliers may have more limited resources to influence these codes and wider regulatory reforms.

3.30. Potential new entrants we spoke to also raised the reputational risks associated with being part of the industry. The ability to provide good customer service in areas like switching are impacted by cross-industry processes. The high level of political and media attention that the sector faces and the poor reputation were seen as risks in using an existing valued brand in the energy market. A consistent reason for not entering the market was the political environment surrounding the energy market and the uncertainties surrounding the future of policy.

[8] As part of this assessment we have sought the views of stakeholders but have not performed a detailed review of these requirements.

3.31. The Assessment also identifies as a feature the requirement by government that suppliers undertake certain social and environmental obligations. The costs of these are passed to consumers through their bills. There is a size threshold (250,000 domestic accounts) below which a supplier is not required to meet these obligations. While this gives small suppliers a cost advantage, the threshold also acts as a barrier to expansion.

3.32. In conclusion, beyond vertical integration, other features of the market that we consider create barriers to entry and expansion are credit and collateral costs, regulatory barriers, supplier pricing strategies (ie the ability to segment the market as described below) and the reputational risks associated with poor industry systems and a strong political focus.

Continuing incumbency advantage and market segmentation

3.33. Issues with potentially weak competition were identified in the Probe and RMR with a particular focus in the Probe on consumer harm experienced by certain segments of the market that were typically more vulnerable. The Assessment updates some of the analysis using the latest data. The Assessment sets out the latest data on market shares and concludes that sticky customers continue to pay more for their energy.

3.34. The six larger suppliers all have a relatively high proportion of customers who never or rarely engage in the market. Suppliers are able to charge these sticky customers higher prices, whilst making cheaper deals available to more active customers. Ofgem has a particular concern that these customers are more often vulnerable.[9]

3.35. We are also aware from our wider work that there are particular sectors of the market where incumbent supplier market shares remain higher than average given particular technical or other features that may make these customers less attractive to serve.[10] Again, these consumers tend to be vulnerable.

3.36. While a difference in prices can act as an incentive to switch, it is clear that a significant number of consumers have never participated in this market or have

[9] For example those who are chronically sick or disabled, the elderly, customers on low incomes, or those living in rural areas.
[10] For example, in our 2013 report on the state of the market for customers with dynamically tele-switched meters we found that in Northern and Southern Scotland the incumbent suppliers has market share of over 90 per cent. Other segments of the market where Ofgem is aware that competition has historically been less effective include off gas grid customers, customers paying by standard credit, customers on independent networks and customers with Economy 7 or Economy 10 meters.

participated so rarely that their actions do not constrain prices. Therefore, we have found that suppliers can exercise market power over their incumbent customers.

Possible tacit coordination

3.37. As set out in the Assessment, when a market is sufficiently stable and rival firms interact repeatedly they may be able to anticipate each other's future actions, enabling them to establish a coordinated course of action without communicating directly. This situation is referred to as tacit coordination between suppliers. Although this does not breach competition law, and is a consequence of individual firms acting independently to maximise their advantage, it can result in prices being higher than they would be in competitive markets.

3.38. As Ofgem found in the RMR, many characteristics of energy retail markets may facilitate tacit coordination. There is a high level of concentration in the market, energy firms' products and cost structures are relatively similar, prices are observable and demand conditions are predictable. High barriers to expansion and the absence of any major disruptive entrant also help to create conditions for supplier coordination.

3.39. The Probe found direct evidence in company documents that companies were active in pursuing strategies, such as matching hedging strategies and pricing relative to a market leader, in order to reduce risk and increase profits. These strategies were found to be carried out independently but could have the effect of reducing competition even if that was not their intent. The Assessment confirms the previous finding that the conditions for coordination are prevalent in retail energy markets.

3.40. We also looked at the behaviour of the six largest energy companies. The Assessment has not concluded whether tacit coordination exists in this market. However, new analysis for the Assessment found a number of aspects of the behaviour of the largest suppliers that appear to be consistent with tacit coordination. It has found that these aspects have become more entrenched recently. This includes the observations that:

- Large suppliers announce price changes around the same time and of a similar magnitude;
- Profitability has increased for all of the large suppliers, and domestic supply margins have converged; and
- The large suppliers appear to raise prices more quickly and fully when costs increase than they reduce them when costs fall.

3.41. In conclusion Ofgem considers that the continuing incumbency advantage and ability to segment the market, together with the evidence of possible tacit coordination, which is becoming more entrenched over time, are features of the market that may have adverse effects on competition.

Outcomes for consumers

3.42. The Assessment includes evidence from the latest Ofgem research[11] that domestic consumer confidence and trust in the market has continued to fall over the last year:

- While "I'm happy with my supplier" remains the principal reason for not switching in 2013, mentions of this have fallen significantly compared to 2012;

- Overall satisfaction with suppliers appears to be in decline, with a 12 percentage point decline over the last five years. The most recent figures indicate a continuing decline and complaints remaining high;

- A total of 43 per cent of domestic customers surveyed did not trust suppliers to be open and transparent with them in 2013, compared to 39 per cent in the previous year. In 2013 nearly one in five consumers (18 per cent) said they 'completely' distrusted suppliers in this regard, up from 13 per cent in 2012.

- Only 52 per cent of customers said they were satisfied with their supplier.

3.43. The Assessment also looks at levels of customer complaints, which have increased by more than 50 per cent since the start of 2011.

3.44. In terms of profitability the Assessment acknowledges the difficulty in reaching firm conclusions in the time available. However it notes that supply profits of the six largest suppliers have increased in recent years. Based on the CSS figures that suppliers are required to produce under licence conditions, current domestic supply margins are on average 4.3 per cent. Some suppliers have stated publicly that they are looking to achieve a supply margin of 5 per cent but the Assessment questions this as an appropriate benchmark noting the low levels of capital and high proportion of bought-in costs in the energy market.

3.45. The overall conclusion of the Assessment in relation to profits is that, based on the data available there are indications that suppliers may have had an

[11] Ipsos MORI Tracker survey 2013

opportunity to earn high profits, although further work is necessary to establish this conclusively. These indicators include rising gas supply margins, relatively high target margins, and signs that costs may not have been at an efficient level across the industry as a whole. This is consistent with a view that competition in the supply market may not be functioning effectively.

3.46. We also note that there has been limited innovation in the market. While there has been innovation around tariffs there has been limited innovation in terms of customer service and suppliers have been slow to move to smart metering. While the assumption has always been that suppliers are unlikely to drive hard to encourage lower energy consumption by their customers in a more competitive market they would be under much greater pressure to meet consumer needs in this way.

3.47. The relative absence of these dynamic benefits of competition means that all consumers, even those who are active in the market, are losing out from competition not being effective.

Small business consumers

3.48. Based on Ofgem's previous work, including on the probe and RMR, we are aware that many of the features identified above also apply in relation to small businesses. We have set out below our views on the extent to which they apply.

3.49. Whilst not all of the features we have considered as part of the assessment apply to small businesses in the same way as domestic customers, Ofgem still takes the view that the reference test is met in respect of small business customers and therefore such customers should fall within the scope of the proposed reference. However, in the event that a reference is made, Ofgem expects that it would be relevant for the CMA to examine any differences between small business and domestic customers in more detail. Consumer groups have made clear that they believe any reference should also include small businesses whose needs are more similar to domestic consumers'.

- **Weak customer response** - Ofgem's latest consumer research with business customers[12] found that most non-domestic consumers (83 per cent) reported they were on a fixed term contract, many for two or three years. Non-domestic consumers' satisfaction with their current supply arrangements and suppliers was generally high although there was an appetite for further streamlining of the switching process. One in seven (14 per cent) said they had switched supplier in the last year. Micro businesses (the smallest

[12] Element energy research – December 2013

category) showed comparatively lower engagement or satisfaction than other businesses across a number of aspects.

- **Vertical integration and wider barriers to entry** - as a structural feature, vertical integration and the implications for liquidity are also relevant to the small business sector although the greater prevalence of fixed term contracts can help independent suppliers manage the hedging risks. Other barriers to entry are also relevant although the levels of consumer protection regulation in the non-domestic market are less than for domestic. There are more independent suppliers active in the non-domestic market and they hold a greater market share than in the domestic market. As set out in the Assessment, for small business customers, which typically have non-half hourly metered sites in electricity and non-daily metered sites in gas, non-incumbent suppliers supply 8 per cent of electricity sites (15 per cent by volume) and 32 per cent of gas sites (66 per cent by volume).

- **Residual incumbency advantage** - while there may be some residual incumbency advantage it is likely to be less marked than in the domestic market given the slightly lower share of the market held by the six largest suppliers. Consumer groups have concerns around the rates which apply where consumers have not actively agreed a contract.

- **Possible tacit coordination** - again evidence of this is less marked in the non-domestic market as prices are currently not widely published. While the domestic price announcements could give an indication of the levels of increases being applied, the existence of a broader competitive fringe could be expected to disrupt potential coordination.

- **Profit levels** - the Assessment shows that profits have declined slightly in the non-domestic market for the six larger suppliers and average margins were 2.6 per cent in 2012 and 3.5 per cent over the period 2009-12. We would expect margins for small businesses to be higher than for other non-domestic customers.

3.50. In the draft terms of reference at Annex 2 we have proposed to include non-domestic customers up to a certain consumption threshold which reflects Ofgem's revised definition of micro-businesses and is the part of the non-domestic market where past Ofgem work has suggested that competition is least effective.

4. The impact of Ofgem's regulatory actions and wider policy developments

Chapter Summary

Ofgem has introduced a number of remedies to improve competition in the market and has further actions in hand. These include the RMR, which is designed to make the market simpler, clearer and fairer. Ofgem has also put in place reforms to increase liquidity which will help independent suppliers to access the wholesale products they need.

However, some stakeholders believe that these reforms do not go far enough. Ofgem notes that consumer trust in the sector is at a very low level and that the ability of the RMR reforms to be fully effective in ensuring greater consumer engagement in the market may be limited. Our liquidity reforms were also not intended to address all the issues with vertical integration. An MIR would complement and run alongside these reforms.

An MIR would permit a comprehensive investigation of the issues of vertical integration and tacit coordination and a detailed review of market profitability.

Introduction

4.1. As highlighted in the previous section the features of the market that we have identified and suspect are having an adverse effect on competition are not new, although there is evidence in some areas that the situation is worsening. Our Probe and RMR identified broadly the same set of problems with the market and put forward remedies aimed at addressing particular features which we believed would unlock competition in the market. In deciding whether or not to make a reference we need to form a view on whether or not the features that have been identified can be expected to persist or whether the remedies that Ofgem has already put in place, or other regulatory actions that Ofgem could take using its powers, could be expected to address them. We therefore set out below the remedies that have most recently been put in place (RMR and liquidity) as well as further actions that are in hand. We then set out our views on how far these can be expected to address the features identified.

4.2. If we proceed to make a reference we would expect to continue with our regulatory actions to protect the interests of consumers. These, plus wider policy developments, would provide important context for any reference, that the CMA would need to take into account.

Retail market developments

Energy Supply Probe

4.3. As noted above the Probe identified a range of features that weakened competition and meant the market was not working in the best interests of consumers.

4.4. Following consultation Ofgem developed measures aiming to address these issues which became effective from September 2009. These included:

- Measures to promote consumer engagement including the requirement for an annual statement as a prompt for engagement;
- Tighter rules to improve the conduct of sales and marketing;
- Voluntary standards of conduct around treating customers fairly;
- Measures to address concerns over unjustified price differentials which were impacting particularly on vulnerable customers.

4.5. We also introduced a range of remedies to address contracting practices affecting microbusiness customers, to help make it easier to switch.

Retail Market Review

4.6. Following the Probe, Ofgem's regular monitoring of the retail market raised concerns that some areas of the market were still not working effectively. The review found that while there had been improvements in certain areas, many of the problems with consumer engagement remained and supplier behaviour had not improved following the introduction of voluntary standards of conduct.

4.7. After further work and consultation Ofgem introduced additional measures to support domestic consumer engagement in three broad areas:

- *Tariff simplification aimed at combating consumer concerns about the complexity and comparability of tariffs.* This limited suppliers to 4 core tariffs per fuel, banned two tier tariff structures and limited the range of discounts that could be offered. In doing this we sought to balance the need to make energy markets more accessible for consumers while also retaining the scope and incentives for suppliers to innovate and compete. These measures came into force at the end of December 2013.
- *Clearer information to aid consumer understanding.* This included new tools to aid comparability (the tariff comparison rate – like an annual percentage rate (APR) in consumer credit – and personal projections). We also set out standard

information that needed to be provided on all bills, annual statements and price change notices to ensure consumers had access to the information they would need to change supplier. We also required suppliers to alert consumers to cheaper tariffs that they had available. These measures are due to come into force at the end of March.

- *Rules requiring fair treatment aimed at rebuilding trust in the market*. This included legally enforceable standards of conduct and rules to prevent suppliers increasing prices where customers are on a fixed term contract. The standards of conduct came into force in August 2013.

4.8. The overall objective of these remedies was to make it easier for domestic consumers to get a better deal in the market and by improving effective consumer engagement to increase competitive pressure on suppliers' pricing and other practices.

4.9. We also introduced remedies to provide businesses with clearer information on their bills about when their contracts end and when they must provide termination notices. The new standards of conduct apply to microbusiness customers in relation to contracts, billing, switching, and deemed contracts.

Other retail market developments

4.10. There are a number of other strands of work that Ofgem currently has in progress aimed at addressing the weak demand side and building on RMR:

- A programme of work looking at the role of **third party intermediaries** (including switching sites and collective switching in the domestic market and brokers in the non-domestic market). Intermediaries have an important role to play in supporting consumer engagement but consumers need to have confidence in the independence of the advice they receive. Ofgem is responsible for the Confidence Code, which governs switching sites, and has recently published proposals for a code of practice for non-domestic intermediaries and a consultation on collective switching.

- A project which is looking at how best to support engagement of the most **vulnerable and sticky customers**. This project came out of RMR (as 'Market Cheapest Deal') but following further discussion with industry and consumer groups we have decided to refocus this work on facilitating the provision of face to face advice to these customers, recognising that they need additional support and confidence building to engage.

- A programme of work looking at how to improve the **switching process**, recognising that concerns about lengthy or problematic switching can be a barrier to consumers engaging. Currently a high proportion of switches take over five weeks – over 80 per cent in gas and 20 per cent in electricity. In addition, 1 per cent of switches are made in error (ie switching the wrong customer). In markets where millions switch each year, even small percentages of errors represent large absolute numbers and can damage customer confidence. We are taking action to improve the speed and quality of switching.

- Continuing work on the **transparency** of energy companies' profits aimed at helping to restore consumer confidence.

Smart metering

4.11. The government has said that all homes and businesses should have smart meters by 2020 and has put licence obligations on suppliers to do this. The main rollout is due to start in 2015. However, some suppliers are rolling out smart meters already and more than 1.3 million smart or smart-type meters were installed by the end of December 2013.

4.12. Smart metering will give consumers much greater visibility and control over their energy use (in part through an in-home display to be given to all domestic consumers) and could be expected to increase consumer engagement. By recording usage on a half-hourly basis and allowing for direct load control, it may also support the provision of innovative services by existing suppliers and new market entrants. These services, including time of use tariffs, should lead to a more active role for consumers in supporting a more sustainable and secure energy market. Most potential new entrants that Ofgem and the OFT have spoken to are looking to use smart metering to help address service quality issues.

Regulatory burdens

4.13. Finally, in terms of barriers to entry, Ofgem is undertaking a project looking at the role of white label suppliers and alternative models such as Ofgem's Licence Lite regime. These models could offer alternative routes for new entrants looking to enter the market but who do not want to have to deal with the complexities of industry arrangements such as balancing and settlement**.** The tariff simplification rules from RMR would limit the scope for White Labels to offer different tariffs from the host licensed supplier. Recognising the potential benefits of the White Label model we have provided an exemption until the end of 2014 while we consider the issue further.

4.14. In the interviews carried out during the Assessment a number of small suppliers highlighted concerns about the impact of RMR on their ability to innovate. When developing our RMR proposals we sought to strike a balance between simplification and allowing room for innovation. As such, we included the ability to provide derogations to specific licence conditions. Given the issues raised through the Assessment we intend to give priority to exploring whether there is further flexibility that could be provided through the derogation process to ensure RMR tariff rules do not act as an undue barrier to entry and expansion.

4.15. As part of our compliance review we are also looking at what more we can do to help small suppliers understand the regulatory framework in which they operate.

DECC is separately considering what measures it can take to reduce barriers imposed by excessive collateral and credit requirements.

Wholesale market developments

Ofgem's liquidity reforms

4.16. Ofgem's liquidity reforms aim to make it easier for small suppliers to enter the market. These reforms have three objectives – availability of products that support hedging; robust reference prices and an effective near term market.

4.17. As part of these reforms we have introduced a new licence obligation into the generation licences of the eight largest electricity generating companies. The licence condition aims to improve access to the wholesale electricity market by requiring these companies to follow a set of 'Supplier Market Access' rules when trading with small independent suppliers. It also aims to ensure that the market provides the products and price signals needed through a market making obligation on the six largest vertically integrated companies. These obligations come into force at the end of March.

The government's Electricity Market Reform (EMR) proposals

4.18. EMR is the government's policy proposals for reforming the electricity system to ensure the UK's future electricity supply is secure, low-carbon and affordable. The key elements of EMR are contracts for difference, which will support new investment in all forms of low-carbon generation and a capacity mechanism which would provide incentives for investment in the overall level of reliable capacity (supply and demand side) needed to secure electricity supplies. The first capacity auctions will be at the end of 2014.

European integration

4.19. The level of physical interconnection with other European markets has increased over the last decade and European legislation (the 'Third Package') aims to create a single European Energy market with common rules to facilitate efficient use of cross-border capacity and to encourage harmonisation of European wholesale market arrangements.

4.20. Interconnectors are the physical links that allow the transfer of electricity across borders and which underpin the European energy network. These connections provide suppliers with access to a wider wholesale market. Increased interconnector capacity would help mitigate competition concerns around vertical integration as well as improving security of supply. Ofgem is carrying out work on the appropriate regulatory framework for interconnectors but any additional capacity would take time to be operational.

European financial legislation

4.21. There are a number of developments in European financial legislation that apply to GB that may have an impact on how participants trade in the wholesale energy markets and hence on levels of liquidity.

Electricity and gas cash-out significant code reviews

4.22. Ofgem is carrying out two significant code reviews looking at the payments made by market participants in the cash-out system to ensure that they have the right incentives to support security of supply and encourage demand side response.

Impact of reforms

4.23. As set out in the Chapter 3 Ofgem consider that there are a number of mutually reinforcing features of the market that we suspect are having an adverse effect on competition.

4.24. Our reforms have focussed on tackling weak customer response through RMR and other retail market measures set out above. Our liquidity reforms are aimed at addressing what we saw as the biggest problems with vertical integration in terms of barriers to entry. In making these reforms Ofgem took the view that addressing these particular features was a proportionate response to the problems at the time and would unlock a more dynamic market with more engaged consumers and stronger new entrants. The expectation was that this in turn would lead to a more competitive market, disrupting any potential for tacit coordination and further eroding any residual market power or incumbency advantage.

4.25. However, some stakeholders consider that these reforms do not go far enough and in a number of areas conditions have actually deteriorated further, making it less likely that these targeted reforms will be sufficient.

Weak customer response

4.26. In considering afresh whether a market reference would be appropriate, Ofgem has considered how the market has changed since it set the direction for RMR. Our main observation is that over the last year consumer trust and confidence in the market has declined significantly, as reflected in a number of metrics in the Assessment and summarised in Chapter 3 above. We note the recent spike in switching but it is not clear whether this will be sustained.

4.27. We continue to see our retail reforms as having a critical role to play. Where consumers do engage in the market our RMR reforms should make this easier and increase the chances of consumers making good choices. However with consumer trust at an all-time low it is unclear that the RMR reforms will be sufficient to drive further consumer engagement. Stakeholders have expressed a range of views as to the likely impact of the reforms with some saying they go far and restrict innovation while others say they do not go far enough. The challenge remains to get consumers to engage.

4.28. The potential for an MIR to help clear the air and restore consumer confidence is the reason a number of the larger suppliers are now advocating a review themselves.

4.29. Our demand side reforms will take time to have an effect. With rising concerns about prices and profits the pace of change is vital and if further action may be needed to address adverse competition effects then we believe it is right to commence that process now to ensure consumers benefit as soon as possible.

Vertical integration and wider barriers to entry

4.30. Similarly we see our liquidity reforms as playing an important role in addressing barriers to entry. Small suppliers generally welcomed the reforms but many stakeholders would have liked them to go further.

4.31. We recognise that there are benefits to vertical integration in terms of cost efficiency (which in a competitive market would be passed on to consumers) and in terms of supporting investment to maintain security of supply. However there are also costs in terms of barriers to entry. In bringing forward our liquidity reforms we were not looking to tackle all aspects of vertical integration but sought to address what we saw as the main problems. We recognise, as we look to explore all avenues to address growing consumer concerns, that there would be value in the CMA looking closely at the balance of costs and benefits of vertical integration given it has the ability to make changes that Ofgem could not, including structural reform, should it consider it necessary.

4.32. The reputation of the industry has also been highlighted as a barrier to entry by some potential new entrants concerned about damage to their brands. Again an independent review has the potential to help address these concerns by helping improve trust and confidence in the sector.

4.33. Ofgem has a strong commitment to better regulation and we have committed to further work to look at some of the regulatory barriers to entry identified. However, there are features of the regulatory framework that are set out in primary legislation that Ofgem cannot change.

Continuing incumbency advantage and possible tacit coordination

4.34. While our RMR tariff reforms may limit the ability of suppliers to segment the market, we have not sought to directly address either the continuing incumbency advantage or possible tacit coordination. Instead, we relied on increasing consumer engagement and reducing barriers to entry to make competition more effective.

4.35. However, given the new evidence in the Assessment about possible tacit coordination we believe that this issue now needs to be explicitly looked at. Moreover, given the uncertainties around whether our reforms will be sufficient to unlock competition in the market, there is clear value in the CMA carrying out a comprehensive review.

Conclusion

4.36. In deciding whether to exercise its discretion to make a reference Ofgem has considered carefully the extent to which the reforms that it has already put in place through RMR and liquidity, plus other projects that it has in hand, could be expected to address the features identified.

4.37. While Ofgem has put in place significant reforms, they do not aim to address all the issues and there are risks, given the worsening context, that they will not deliver the transformational effect required. Our view is that an in-depth and comprehensive review of the market is necessary to examine the features identified and the complex interplay between them, to reach a definitive view on the best way to address any enduring competition concerns. In so far as the same features also apply to the small business market we would expect the CMA to consider them as part of any investigation.

4.38. The energy sector is on the cusp of major change with the rollout of smart metering, the proposed introduction of electricity market reform and the move to an integrated Europe-wide market. If we made an MIR, we would expect the CMA to take such developments into account when conducting its market investigation and considering the design and appropriateness of any remedies.

5. Exercising our discretion to propose a reference

Chapter Summary

In deciding whether to exercise our discretion to propose a reference Ofgem needs to consider whether to do so would be in the interest of existing and future consumers. We have also had regard to the OFT guidance.

An MIR would be valuable in providing a comprehensive investigation of the features identified and ultimately providing consumers with increased confidence in the working of the market.

The CMA is well placed to analyse these issues using its experience of other sectors and has broader powers to draw on should it consider structural change is needed. Delaying to see what the effects of our reforms are would only prolong the investment uncertainty and delay the benefits to consumers of any remedies that the CMA may propose.

Ofgem is therefore now proposing to make a reference, and seeks views on our proposed decision.

5.1. As set out in Chapter 1, Ofgem considers that, subject to consultation, it is able to exercise its powers to make an MIR to the CMA given that it has reasonable grounds for suspecting that there are features of the energy market that prevent, restrict or distort competition

5.2. In deciding whether to exercise our discretion to make a reference we need to decide whether to do so would be in line with our principal objective to protect the interests of existing and future energy consumers.

5.3. The OFT’s guidance sets out the following four criteria to guide regulators in considering whether to make an MIR:

- The suitability or otherwise of using our Competition Act 1998 or other sectoral powers.
- Whether the problem could be addressed through undertakings.
- Proportionality and whether the scale of the suspected problem, in terms of its adverse effect on competition, is such that a reference would be an appropriate response.

- Whether there is a reasonable chance that appropriate remedies will be available.

5.4. Ofgem has had regard to these issues alongside our principal objective to protect the interests of existing and future energy consumers.

Key aspects of the consumer interest

5.5. In reaching a view on the consumer interest we took account of a number of factors including:

- Whether the features are likely to endure or whether we expect that our existing remedies or other developments in the market will resolve them.
- Whether there are plausible steps the CMA could take that we can't to address the persistent problems in the market.
- Whether making a reference would create undue risks for security of supply through damaging investor confidence.
- Whether making a reference would restrict our ability to deliver on other expected developments of regulation that are in the consumer interests.
- Whether vulnerable consumer interests would be appropriately addressed in the making of a reference.
- Whether now is the right time to make a reference or whether we should wait to see the effect of our reforms.

5.6. These factors are discussed in turn below.

Whether the features are likely to endure or whether we expect that our existing remedies or other developments in the market will resolve them.

5.7. As discussed in Chapter 3, the features of the market that have been identified, and which we suspect are having an adverse effect on competition, are persistent and were observed in the Probe as far back as 2008. Whilst there have been some changes to the market shares of the six largest players, the structure of the market remains relatively stable and there has been no major disruptive entrant since market opening.

5.8. As discussed in Chapter 4, Ofgem's RMR reforms aim to improve competition by creating a simpler, clearer and fairer market. However consumer trust and public confidence has continued to decline which means that there is a real risk that our RMR remedies alone will not have the transformational impact on consumer engagement that is required to break the pattern of weak competition.

5.9. Ofgem's liquidity reforms are not intended to address the full range of issues associated with vertical integration and wider barriers to entry that might prevent a major disruptive entrant from entering the market. Many stakeholders argued that they did not go far enough. Other policy developments such as smart metering may be disruptive to the status quo, but over a longer time frame.

5.10. Given the persistence of the issues and the complex way in which the features inter-relate there is a real risk that our remedies will not fully address the problems identified. Moreover, Ofgem’s reforms do not specifically address the issues of potential tacit coordination which the latest evidence highlights as a growing concern.

Whether there are plausible steps the CMA could take that we can’t to address the persistent problems in the market

5.11. Ofgem has wide powers and is taking a range of steps aimed at improving the effectiveness of the market (see Chapter 4). However, an MIR would permit a comprehensive investigation of vertical integration and tacit coordination as well as detailed analysis of profitability. The CMA is well placed to use its experience to analyse these issues.

5.12. The CMA has further powers, including the ability to make structural reforms, which could enable it to take steps not available to Ofgem to address these persistent problems should it conclude that it is necessary. Such reforms could include action to address the problems of vertical integration or potentially structural solutions to the problems of incumbency.

Whether making a reference would create undue risks for security of supply through damaging investor confidence

5.13. Significant investment is needed in the near term to ensure security of supply and DECC will be holding capacity auctions at the end of 2014. A reference could impact investor perceptions of the level of market uncertainty, particularly given the possibility of structural remedies. Higher perceived risks could increase bids in the capacity mechanism which could potentially raise prices to consumers.

5.14. However we are also aware that the current market and political uncertainty is already creating concern among investors. The alternative of waiting to see the impact of our reforms would leave the prospect of a reference as a risk to investment for a longer period.

5.15. The CMA process is transparent and independent and all stakeholders would have opportunities to feed in their views. In the event of a reference, if stakeholders have any concerns about the implications of the CMA’s findings for security of supply they could feed them into that process.

Whether making a reference would restrict our ability to deliver on other expected developments of regulation that are in consumers’ interests

5.16. There is no statutory bar on Ofgem continuing to regulate to ensure that consumers' interests are protected during an MIR, and we believe it is important that we continue with the important programme of work set out in Chapter 4 and in our Forward Work Plan. We recognise however the need to be proportionate and avoid duplication of effort. We would therefore consider carefully any actions in areas that might be impacted by potential remedies that the CMA might be expected to introduce, in particular if significant costs were involved.

Whether vulnerable consumer interests would be appropriately addressed in the making of a reference

5.17. The CMA is not obligated to consider the particular needs of vulnerable consumers in any assessment of whether the market is working effectively. However their guidelines do allow them to take account of the interests of particular groups if they wish to do so and the Competition Commission has done so in the past for example in its work on payday lending. In developing remedies, if they intend to give them effect through licence conditions they would need to take account of our principal objective and wider statutory duties. In our view an important test of whether the market is working effectively is whether it is working for all consumers and we would anticipate that the CMA will be alive to concerns that particular disadvantaged groups are losing out.

5.18. In addition as noted in Chapter 4 Ofgem will continue the work that came out of RMR to look at what more can be done to help the most vulnerable and sticky customers engage in the market through facilitating the provision of more face to face advice.

Whether now is the right time to make a reference or whether we should wait to see what the effect of our reforms are

5.19. Given the high levels of concerns about bills and profits we consider that it is right to set this process in train now so that if further changes are needed consumers can benefit at the earliest opportunity.

5.20. Moreover leaving open the possibility of a reference would have potentially negative impacts on investment and delay the conclusion of that period of uncertainty.

5.21. As the reference progresses the CMA would be able to take account of emerging evidence about the effectiveness of Ofgem's reforms.

OFT guidance

5.22. As set out above, the OFT has published guidance on the criteria it would apply in deciding whether to exercise its discretion to make a reference. While this guidance is not binding on Ofgem, we have considered these issues alongside our principal objective to protect the interests of existing and future energy consumers.

Alternative powers

5.23. We have considered whether the competition problem or problems we have identified may involve an infringement of the Chapter I and II prohibitions of the Competition Act 1998 and the prohibitions set out in Articles 101(1) and 102 of the Treaty on the Functioning of the European Union ('competition law'). We have not received any evidence that suggests there has been a potential breach of competition law.

5.24. We have considered whether the problems identified could be addressed through the use of sector regulation. However, as set out above, given the complexity and persistence of the problems in the market there may be a need for remedies, such as structural reform, that Ofgem does not have the ability to make.

Undertakings in lieu of an MIR

5.25. Ofgem has power under s.154 of the Enterprise Act to accept undertakings instead of making an MIR. Ofgem has already introduced the remedies that it has been able to identify as needed, and without a full CMA investigation, it is not clear what remedies would be appropriate. Ofgem also considers that undertakings in lieu may not be an appropriate given the number of companies which operate in the energy market and the nature of the market features Ofgem has identified.

Scale of the problem

5.26. The OFT guidance identifies three factors as relevant to whether an adverse effect on competition is significant, and thus whether a market investigation reference would be a proportionate response: the size of the market, the extent of the problems within the market and the likely persistence of these problems.

5.27. In Ofgem's view, an MIR would be an appropriate, and proportionate, response consistent with our better regulation duty, given that:

- The size of the market is significant, with domestic supply revenues of £28bn for the six largest suppliers in 2012.

- Concerns that we have about this market potentially affect almost all homes and small businesses in Great Britain.

- The problems are persistent and Ofgem's reforms will not address all the features identified.

Availability of remedies

5.28. As set out in Chapter 2, the CMA has wide-ranging powers, including the ability to make structural reforms that Ofgem cannot.

5.29. In addition, Ofgem sees the potential for an independent investigation by the CMA to restore consumer, business and, potentially, investor confidence in the market.

Conclusion

5.30. On the basis of the considerations set out above Ofgem believes that it would be in consumers' interests to make a Market Investigation Reference to the CMA.

Appendices

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Appendix 1 - Consultation response and questions

1.1. We'd like to hear your view on any of the issues in this document.

1.2. Responses should be received by **Friday 23 May 2014** and sent to:

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1.3. Unless marked confidential, we will publish all responses in our library and on our website www.ofgem.gov.uk. You may ask us to keep your response confidential. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.4. If you'd like your response to remain confidential, clearly mark it to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Please restrict any confidential material in the appendices to your response.

1.5. Any questions on this document should, in the first instance, be directed to:

State of the market
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London
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Appendix 2 – Draft terms of reference

Terms of reference:

"the supply and acquisition of energy in Great Britain"

Definitions:

'acquisition' means the wholesale purchase or trading of energy for purposes which may ultimately include retail supply;

'energy' means:

(a) electricity generated for purposes which include its potential conveyance to any relevant premises and/or

(b) gas which has been or is intended to be conveyed through pipes to any relevant premises;

'relevant premises' means premises at which energy is or is to be consumed by a person who:

(a) is a relevant consumer for the purposes of in article 2(1) of The Gas and Electricity Regulated Providers (Redress Scheme) Order 2008 (S.I. 2008/2268); or

(b) has an annual electricity consumption of not more than 100,000 kWh; or

(c) has an annual consumption of gas of not more than 293,000 kWh;

'retail supply' means supply to relevant premises by a person pursuant to a gas supply licence granted or treated as granted under section 7A(1) of the Gas Act 1986 and/or an electricity supply licence granted or treated as granted under section 6(1)(d) of the Electricity Act 1989;

'supply' means the activities of, and activities connected with, wholesale supply and retail supply of energy