

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

Final decision

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Overview:

This document sets out our decision to refer the retail energy market to the Competition and Markets Authority for investigation.

Context

In November 2013 we agreed to work with the Office of Fair Trading and the Competition and Markets Authority (CMA) to produce an assessment of competition in the retail energy market. This assessment was published on 27 March 2014 alongside a consultation on our proposed decision to make a market investigation reference to the CMA.

This document sets out our decision to refer the retail energy market to the CMA for investigation.

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 – 27 March 2014

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

Consultation on a proposal to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain – 27 March 2014

<https://www.ofgem.gov.uk/ofgem-publications/86807/consultationpublish.pdf>

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Executive Summary

Ofgem is referring the market for the supply and acquisition of electricity and gas to the Competition and Markets Authority for further investigation. Our reference covers supply to domestic and small business customers. The CMA will conduct a thorough examination of the market and, if necessary, will be able to use its wide-ranging powers to remedy the features of the market that have an adverse effect on competition. Our decision is based on:

- The findings of the State of the Market report, carried out with the Office of Fair Trading and CMA and published in March 2014;
- The persistence of these problems with the market, despite a series of Ofgem investigations and reforms to the market;
- Our consultation document and stakeholders' views on our proposed decision to refer. These were generally supportive of our position.

In coming to our decision, we have had regard to Ofgem's principal objective and general statutory duties, including by considering the impact of our decision on consumers in vulnerable situations, security of supply and our ability to protect consumers' interests while the inquiry is progressing. We have also considered alternative courses of action.

During its investigation, the CMA will seek to identify features of the market that have an adverse effect on competition. The State of the Market report identified the principal market features that may have a harmful effect on competition, outlined below. The CMA has discretion to look at any issue within the terms of reference, including those beyond the issues below.

- **Weak customer response.** Evidence that customer activity in the market is low, and trust is low, which is preventing the process of competition from working effectively.
- **Incumbency advantages.** Suppliers that gained a large customer base when competition was introduced continue to charge higher prices to their less active customers. This suggests competition is not working effectively for all customers.
- **Possible tacit coordination.** We found no evidence of direct coordination, but there is evidence of possible tacit coordination, which can weaken competitive rivalry between companies.
- **Vertical integration.** Vertical integration is prevalent in this market. It can provide efficiency benefits but can also harm competition. A full investigation of the balance between costs and benefits is needed, to establish whether vertical integration is best for competition.
- **Barriers to entry and expansion.** Barriers identified in our report included credit and collateral requirements, low wholesale market liquidity, extensive industry regulation, and policy uncertainty.

These key features of the market contribute to poor outcomes for consumers, including increasing retail profitability and low levels of consumer trust. In addition to the principal features listed above, our work has identified a number of other features that the CMA may wish to consider. We will set these out in subsequent submissions to the CMA.

The energy market is going to change significantly over the next few years as a result of the rollout of smart meters, the government's electricity market reforms, and closer integration with other European energy markets. A more competitive market will help to deliver the benefits of these changes to consumers and a market investigation by the CMA is the best way to achieve this. In developing its remedies to any competition problems it may identify, the CMA will need to make sure that any eventual remedies are effective alongside these changes.

There are also areas of the market that we do not think are so problematic. They include wholesale gas, provision of transmission and distribution of electricity and gas, gas storage, interconnection and settlement reform. We do not think these areas warrant specific investigation as part of a market investigation, as we have found no evidence that they are having a detrimental impact on competition.

We intend to play a full part in the investigation and will assist the CMA by providing information, data and expertise, as well as submitting our views on competition in the energy market. Energy is an essential service and is vital to the economy. It is also a heavily regulated sector. We expect the CMA to look at the regulatory framework and how it is applied as part of its investigation.

1. Introduction

- 1.1. Rising energy prices have renewed public scrutiny of the energy market. Effective competition can help to put downward pressure on prices, as well as improving quality and innovation. For some time the retail market has not been working as it should. We have implemented reforms to make competition work better for consumers, most recently with the Retail Market Review (RMR). These reforms aim to make the market simpler, clearer and fairer for consumers. We have also just introduced wholesale market reforms. These liquidity reforms aim to help independent suppliers and generators to buy the products they need from wholesale markets and to make prices clearer.
- 1.2. We are committed to monitoring the market and the impact of our reforms. As part of this commitment, each year we will publish an assessment of competition in the retail market. This year's assessment¹, which was carried out jointly with the Office of Fair Trading (OFT) and the Competition and Markets Authority (CMA), was published in March 2014.
- 1.3. As a result of this year's assessment, and taking into account our principal objective and other duties, we proposed to refer the gas and electricity supply markets to the CMA.^{2,3} The consultation on our proposal closed on 23 May 2014.
- 1.4. Twenty-eight organisations responded to our consultation, along with seventy-eight consumers. Nearly all of them supported a referral to the CMA. Respondents gave three main reasons: providing a definitive examination of competition to restore consumer confidence; a chance to fix problems with the market; and supporting investor confidence. Some stakeholders disagreed with our conclusions about the state of competition in the market, but many of those who did thought that it was appropriate for the market to be referred to the CMA.
- 1.5. We have taken their views into account in our decision to refer and our final view on the market features that the CMA should investigate. In chapter 2 we explain our reasons for referring the market to the CMA and what stakeholders thought about each reason. In chapter 3 we describe the key features of the market that we think could be harming competition. We summarise stakeholders' responses in appendix 2.

¹ Ofgem, OFT and CMA, 'State of the Market Assessment', 27 March 2014

² 'Consultation on a proposal to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain', Ofgem, 27 March 2014. And 'State of the Market Assessment', Ofgem, CMA and OFT, 27 March 2014

³ 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.

2. Our decision to make a market investigation reference

- 2.1. We have decided to make an ordinary reference to the CMA for a market investigation into the supply and acquisition of energy in Great Britain.⁴ We consider that the relevant legal test has been passed, and that a market investigation is in consumers' interests. This chapter outlines our reasons for doing so.

The reference test and legal framework

- 2.2. To make a market investigation reference ('a reference'), Ofgem must have reasonable grounds for suspecting that any feature or combination of features of goods and services market in Great Britain prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in Great Britain or as part of Great Britain (the 'reference test').⁵ If this threshold is met, then Ofgem can choose whether to exercise its discretion to make a reference.
- 2.3. The reference test outlines three types of market features that could have an adverse effect on competition. These are structural features, firms' conduct and customers' conduct.⁶ We assessed the state of the market jointly with the OFT and the CMA. This assessment identified a series of market features that are potentially harming competition. Chapter 3 outlines these features and their effect on competition, alongside views voiced by stakeholders in their consultation responses.
- 2.4. When exercising our powers to make a reference Ofgem is subject to its principal objective of protecting the interests of existing and future energy consumers. The interests of such consumers are taken as a whole and include their interests in the reduction of greenhouse gases, security of supply and fulfilment of the objectives in the EU Gas and Electricity Directives.⁷
- 2.5. When exercising regulatory functions Ofgem is required to further its principal objective, by promoting effective competition where appropriate. However, before performing regulatory functions with a view to promoting competition, Ofgem must always first consider the extent to which consumer interests would be protected by promoting competition and whether there are other better ways to protect consumer interests.
- 2.6. The CMA and Ofgem have concurrent powers to refer markets under part 4 of the Enterprise Act. In accordance with statutory requirements, Ofgem has consulted with

⁴ As defined in the terms of reference set out in Appendix 1

⁵ S.131(1) of the Enterprise Act 2002. While the test itself refers to the United Kingdom, we refer to Great Britain because of our jurisdiction.

⁶ S.131(2) of the Enterprise Act 2002

⁷ Such as promoting competition, helping to ensure consumer protection and contributing to the protection of consumers in vulnerable situations.

the OFT⁸ on its intention to exercise concurrent powers and has confirmed with the OFT that, in this instance, it is appropriate for Ofgem, as the sector regulator, to exercise such powers.

- 2.7. In accordance with section 169 of the Enterprise Act, Ofgem consulted on its proposal to make a reference. We issued this consultation on 27 March 2014 and it closed on 23 May 2014. Our decision to make a reference has been informed by responses to this consultation. This document sets out the reasons for our final decision and how we have accommodated respondents' views.

Reasons to refer the market

- 2.8. To reach this decision, we have considered the following issues alongside our principal objective:

- Whether the features are likely to endure or whether we expect existing remedies or other market developments to resolve them;
- Whether the CMA could take steps that we could not, to address persistent problems in the market;
- Whether making a reference would create undue risks for security of supply by harming investor confidence;
- Whether making a reference would slow or prevent progress on other regulation that is in consumers' interests;
- Whether the interests of consumers in vulnerable situations would be appropriately accommodated if we made a reference; and
- Whether now is the right time to make a reference, before we have seen the full effect of recent reforms.

- 2.9. These issues were set out in the consultation document and are discussed in more detail below.

Whether the features are likely to endure or whether we expect existing remedies or other market developments to resolve them

- 2.10. We first identified the potential harmful features outlined in chapter 3 during the 2008 energy supply probe ('the probe'). Our assessment showed that many of these features still remain or have worsened, particularly customer switching and engagement.

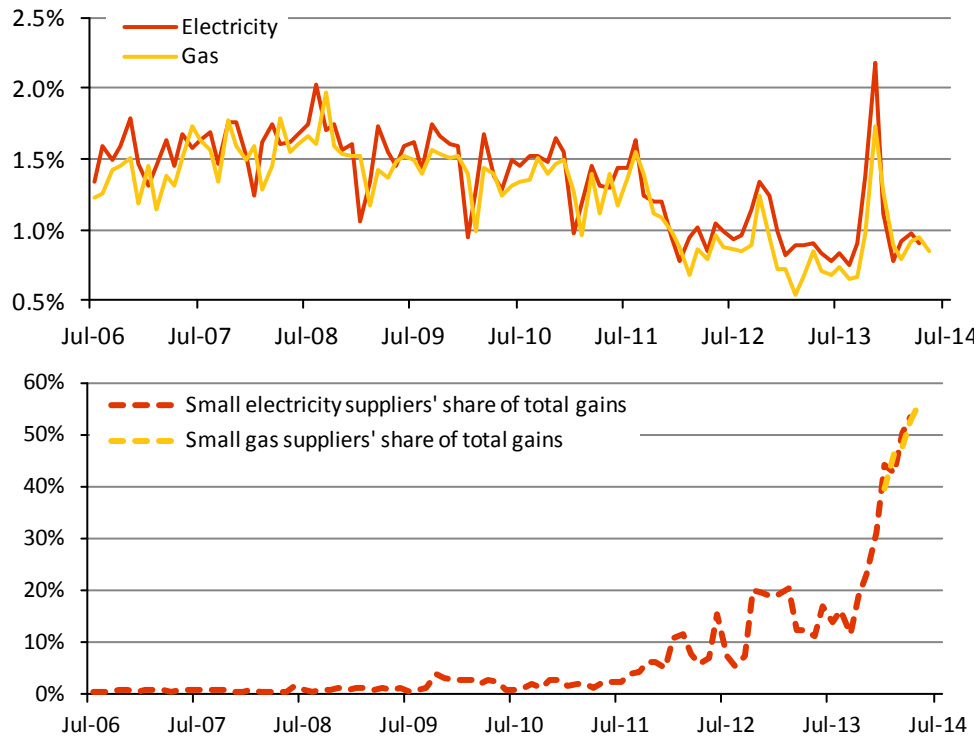
- 2.11. The state of the market assessment ('the assessment') identified a spike in switching activity in November 2013. At the time we questioned whether this might be the beginning of a new trend. The most recent data available suggests otherwise, showing switching falling back again to the longer-term trend (Figure 1).⁹ On the

⁸ The competition functions of the OFT passed to the CMA on 1 April 2014.

⁹ The average monthly switching rate between Jan 2010-Oct 2013 was about 1.2% for electricity and 1% for gas. It was about 0.9% and 1% respectively for the Dec 2013-April 2014 period.

other hand, those switching are increasingly choosing small suppliers, accounting for more than half of all switches in April 2014.

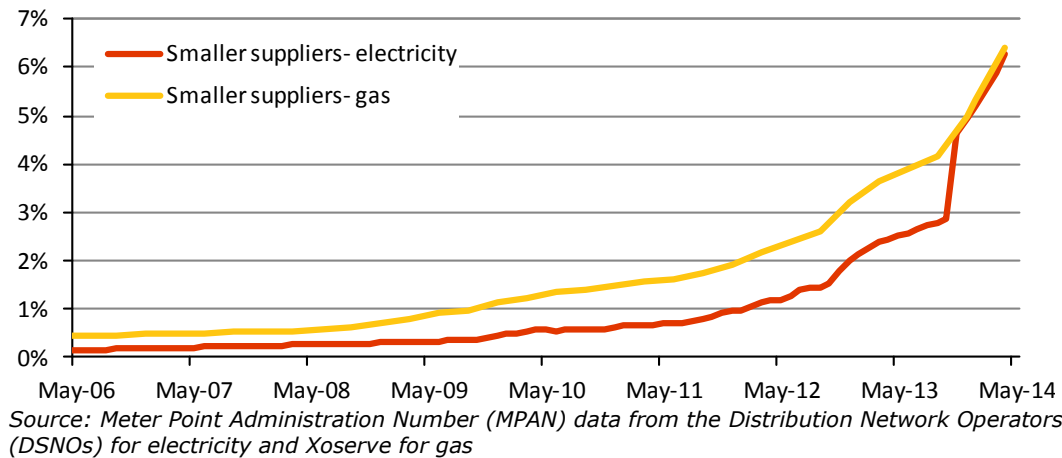
FIGURE 1: MONTHLY DOMESTIC SWITCHING RATES AND SMALL SUPPLIERS' SHARE OF DOMESTIC CUSTOMER GAINS



Source: DNOs, large suppliers for gas until Dec 2013 (and Utility Warehouse since Nov 2013), Xoserve (for gas since Jan 2014)

2.12. As a result, small suppliers are growing more quickly and now make up more than six per cent of the market in domestic gas and electricity (Figure 2).

FIGURE 2: TOTAL SMALL SUPPLIER DOMESTIC SUPPLY MARKET SHARES; GAS AND ELECTRICITY



2.13. The increasing importance of smaller suppliers is positive for competition. However, these recent developments are not enough to conclude that the market features we have identified will disappear. Retail supply entry and the expansion of smaller suppliers have not significantly disrupted the market structure or conduct of incumbent retail suppliers. Even if current trends continue, this position is unlikely to change in the short to medium term. We also remain concerned that the increased competitive pressure from the small suppliers is confined to certain parts of the market.

2.14. In their responses to our consultation, some stakeholders argued that competition is more effective than the the assessment suggested. They highlighted recent developments such as more customers switching to small suppliers. Other stakeholders supported our conclusions and did not agree that recent positive signs are enough to undermine the harmful market features we have identified.

2.15. We designed RMR remedies to improve competition by creating a simpler, clearer and fairer market. Despite the increase in switching, there is a risk that these remedies might not transform engagement enough to break the pattern of weak competition. Latest information shows that consumer trust and public confidence remain low (see below).

2.16. We have also implemented liquidity reforms designed to make it easier for small suppliers to participate in the wholesale market, but some barriers remain. The reforms are also not intended to undermine efficiencies that larger companies and their customers can gain from vertical integration.

Whether the CMA could take steps that we could not, to address persistent problems in the market

2.17. Ofgem continues to use its powers to make the market work better for consumers. Our decision to refer the market will lead to a comprehensive investigation into the

costs and benefits of vertical integration. We also expect the CMA to conduct a detailed analysis of profitability and tacit coordination. The CMA is well placed to use its experience of competition in other sectors to examine these issues and we think this investigation will complement our ongoing work to protect consumers.

- 2.18. The CMA also has remedy powers that Ofgem does not, including the ability to make structural reforms if needed. Any such reforms might help mitigate the adverse features arising from vertical integration, incumbency or other market features. Many stakeholders supported this rationale.

Whether making a reference would create undue risks for security of supply by harming investor confidence

- 2.19. To maintain security of supply, a stable investment climate is needed. On balance, we think our decision to refer the market will not unduly risk security of supply.
- 2.20. We considered whether the uncertainty of the market investigation process and the possibility of significant remedies could increase investors' perceptions of risk. This could deter investment, or raise bids into the capacity mechanism, which aims to improve security of supply by purchasing capacity in auctions taking place at the end of 2014.
- 2.21. However, we are not convinced that the alternative option, to not make a reference, would offer investors more certainty. The market is currently characterised by a high level of regulatory and political uncertainty, and it is not clear that this would change in the absence of a market investigation. Furthermore, the CMA's market investigation process is independent and transparent, which should mitigate some of the uncertainty arising from the process.
- 2.22. Many of our stakeholders agreed with our view. Most thought that a decision to refer better for investment prospects than a decision not to refer. Nine respondents said this was one of their main reasons for supporting a referral. Only one respondent said that that an market investigation would increase investor uncertainty.

Whether making a reference would slow or prevent progress on other regulation that is in consumers' interests

- 2.23. As mentioned above, we have already made major reforms to the retail market and are targeting liquidity in the wholesale market. During its investigation, the CMA will be able to examine whether these reforms are having their desired effect. Two respondents said that in the meantime we should avoid big rule changes.
- 2.24. Our plans for future work are described in our Forward Work Programme.¹⁰ We do not think this work entails the major rule changes that some stakeholders have warned against, or would duplicate the CMA's work during its investigation. Neither do we expect to require industry to implement reforms that might need to be

¹⁰ Ofgem, 'Forward Work Programme 2014-15', 31 March 2014

changed once the CMA concludes its investigation. We will keep this under review during the investigation.

Whether vulnerable consumers' interests¹¹ would be appropriately accommodated if we made a reference

- 2.25. We are confident that the CMA will include the interests of vulnerable consumers in its investigation. We expect them to look at whether competition is working for all consumers, including vulnerable consumers. We note that the CMA (and previously the Competition Commission) has specifically considered vulnerable consumers in previous investigations. Should the CMA implement remedies through licence conditions, it must have regard to Ofgem's principal objective and statutory duties, including protecting the interests of consumers whose situation makes them vulnerable.
- 2.26. During the investigation we will continue work to encourage vulnerable or reluctant customers to shop around, for example by encouraging more face-to-face consumer advice. Some stakeholders noted the importance of vulnerable consumers, and supported our view that the CMA should consider vulnerable customers when assessing how well competition is working for all consumers.

Whether now is the right time to make a reference, before we have seen the full effect of recent reforms?

- 2.27. As set out in our consultation, we consider that the high levels of concern over bills and profits mean that an investigation starting now will allow customers to benefit at the earliest opportunity from any further changes, if the CMA decides they are needed. The latest evidence on consumer trust is mixed, but we see no clear indication that consumers' trust in suppliers is improving. Any further delay in our decision to refer the market or not could also exacerbate investment uncertainty.
- 2.28. The CMA has powers that Ofgem does not, so regardless of the success or otherwise of Ofgem's policies, referring the market will ensure that all possible steps can be taken to improve competition in their interests. Making a decision now is the best way to achieve that.
- 2.29. Our RMR and liquidity reforms are now in place and the CMA will be able to incorporate any evidence on the effectiveness of our remedies as it emerges during their investigation. Furthermore, the mass rollout of smart metering will begin soon. The availability of data from smart meters and the communications platform that they provide could have a big impact on how the retail market operates. Making a reference now will also help make sure the market is competitive as smart metering is rolled out, so that consumers get the full benefits.

¹¹ By vulnerable consumers, we mean consumers who find themselves in a vulnerable situation.

Other considerations

2.30. As part of reaching our decision, we have also had regard to policy considerations set out in CMA guidance¹² on when a reference may be appropriate. This guidance describes each of the factors outlined below.

Alternative powers

2.31. Using our competition law powers is one potential alternative, but we have found no evidence of competition law infringement. By 'competition law', we mean 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.

Undertakings in lieu of a reference

2.32. Ofgem can accept undertakings instead of making a reference under section 154 of the Enterprise Act. We think this would not be appropriate now, because without more investigation it is not clear what further remedies are needed beyond those already in place. Undertakings in lieu of a reference would not be appropriate because of the large number of companies which operate in the sector.

2.33. A reference is an appropriate and proportionate response to the market features that we identify. The CMA guidance identifies three significant factors; the size of the market, the extent of the problems identified and the likely persistence of these problems.

2.34. Domestic supply revenues for the largest six suppliers are clearly significant, at £28bn for the largest six suppliers in 2012. The problems that we have identified potentially affect nearly all homes and small businesses in Great Britain. These problems are also persistent and the reforms that have recently implemented cannot address all of the features that we have identified.

Availability of remedies

2.35. The CMA has wide-ranging powers, including the ability to make structural reforms that Ofgem cannot. In addition, we see the potential for an independent investigation by the CMA to restore consumer, business and, potentially, investor confidence in the market.

Scope

2.36. Our description of the features of this market should be a starting point for the CMA. Within the scope of the terms of reference that we outline in Annex 1, the CMA may

¹² "Guidance about the making of references under Part 4 of the Enterprise Act", March 2006 (OFT 511). This guidance was originally produced by the OFT but has been adopted by the CMA.

choose to look at any issue connected with the supply or acquisition of energy in GB. This includes both retail and wholesale markets. Wherever the CMA chooses to focus their investigation, we will support it and contribute our knowledge of the markets.

2.37. The terms of reference expressly mention “activities connected with” retail and wholesale supply. Ofgem intends this concept to have a broad meaning in order to allow the CMA to properly investigate market features relating to customer engagement, market segmentation and barriers to entry and expansion. On this basis, the terms of reference are intended to capture things such as:

- the effect of industry code requirements connected to distribution, transportation and transmission services, for example, collateral requirements associated with network codes;
- the roles played by third-party intermediaries;
- goods and services which are ancillary to retail supply or otherwise linked due to contractual arrangements or the way they are marketed. For example, the CMA can investigate whether bundling the provision of boiler services with energy supply arrangements affects retail supply competition, but not the boiler services market itself.

2.38. The terms of reference restrict the CMA to investigating domestic and micro-business retail supply.¹³ The terms of reference exclude the market for retail supply to larger customers, because we have little evidence of harmful features on those markets. We have set the terms of reference widely in terms of which customers qualify as micro-businesses, by including new consumption criteria that Ofgem has used since 31 March 2014. This will allow the CMA to come up with appropriate definitions for the economic markets serving micro-businesses. It will also be able to tailor specific remedies for these groups if necessary.

2.39. The terms of reference that we have set is also intended to cover the regulatory framework and how it is applied. We would expect the CMA to examine our role in market regulation, our powers and statutory duties and the effect of our policies to increase competition and protect consumers. In addition, we would also expect the investigation to look at wider industry regulation, including the process for making changes to industry codes.

2.40. Most respondents did not focus on the wording of the terms of reference that we consulted on. These terms of reference leaves the CMA with choice over where to focus their investigation and stakeholders focussed on that question. Some larger suppliers wanted the investigation to include larger business consumers. Others agreed with the assessment that the larger non-domestic market is more competitive. Our assessment, and previous Ofgem work, has found that there is more effective competition and better outcomes in the retail non-domestic market, but that smaller business consumers face many of the same features as domestic

¹³ The effect of our terms of reference is that a micro business is defined on the basis of criteria relating to energy consumption or business size. The consumption criteria captures electricity business consumers with consumption not more than 100,000 kWh and gas business consumers with consumption not more than 293,000kWh. The business size criteria captures a business with fewer than 10 employees and an annual turnover or annual balance sheet total not exceeding 2 million Euros.

consumers. The concentration of harmful market features in the domestic and micro-business markets reflects these findings.

Next steps

2.41. The CMA will now begin a market investigation in respect of the supply and acquisition of energy in Great Britain under terms of reference set out in appendix 1. It will investigate whether there are any market features that have an adverse effect on competition. Should it find that there are such features, the CMA must¹⁴ take such action as it considers reasonable and practicable to 'remedy, mitigate or prevent' the adverse effect on competition and any detrimental effects on customers (in so far as those effects have resulted from the adverse effect on competition).

¹⁴ Section 138 of the Enterprise Act 2002

3. Key features of the energy supply market

- 3.1. As part of our RMR, we made a commitment to publish an annual assessment of the state of the retail market. The assessment carried out jointly with the OFT and the CMA was the first of these reports.¹⁵ It included new analysis and incorporated evidence from over 40 interviews with stakeholders including small suppliers and potential market entrants. It also combined Ofgem's expertise with the OFT and CMA's experience of market assessments.
- 3.2. In the assessment, we found market features that we first identified in the probe were still present. We explained our ongoing concern about the persistence of these features and their potential to harm consumers' interests and market competitiveness.
- 3.3. We have updated our conclusions with information provided in stakeholders' responses and with updated market information that has been made available since we published our consultation. In the following sections we set out stakeholders' views on the key features we have identified and provide updated evidence received since March 2014. We also outline some questions that we think the CMA should consider in relation to each of the key features of the market.
- 3.4. In addition, we have identified a number of areas where, based on our ongoing monitoring and knowledge of the market, we have not found evidence of a significant adverse effect on competition.

Weak customer response

- 3.5. In an effective market, customer response drives competitive pressure, for example through switching.¹⁶ The assessment found that in parts of the market this is not happening. Weak customer response is a feature of this market that we have consistently observed for some years. Customer response is not showing enough signs of improvement to allay our concerns about its detrimental impact on competition.
- 3.6. Energy is an essential product and affordability is a real concern for most consumers. However, many have little inherent interest in energy products. Our RMR found that many consumers were put off shopping around by the number of tariffs and the difficulty of comparing complicated deals. Many consumers did not have clear information to be able to assess their options easily. Poor supplier conduct

¹⁵ 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.

¹⁶ As set out in: Ofgem, CMA and OFT, *State of the market report – Assessment framework*, December 2013. Available at: <https://www.ofgem.gov.uk/ofgem-publications/85260/assessmentframework18decfinal.pdf>

contributed to low consumer engagement by leading many consumers to distrust suppliers and the market.

- 3.7. Ahead of RMR remedies coming into force, research in 2013 showed that many consumers continued to find it difficult to compare tariffs. Fifty-four per cent of consumers understood tariffs 'not very much' or 'not at all'.¹⁷ We have seen some improvement in our 2014 research, we found that forty-seven per cent of consumers understood tariffs 'not very much' or 'not at all'.¹⁸
- 3.8. Overall satisfaction and trust in suppliers is still low and shows few signs of improvement. Our latest consumer engagement tracking survey from March 2014 shows trust levels that are similar to last year. Forty-four per cent of household customers distrust energy companies to be open and transparent in their dealings with consumers (Figure 3).¹⁹ On a more positive note, the proportion of the same group of consumers who distrust suppliers 'completely' is down three points from last year, to 15 per cent.²⁰
- 3.9. Some larger suppliers and EnergyUK suggested trust in the energy supply industry is greater than we concluded in the assessment. Work commissioned by EnergyUK found 48 per cent of customers trusted their own supplier to be open and transparent in their dealings with them²¹ (compared to findings from research commissioned by Ofgem that only 29 per cent trust suppliers in general to be open and transparent in their dealings with customers).²²
- 3.10. Care is needed in comparing results from different surveys. Measures of trust are very sensitive to how the question is worded. Therefore we accept there are likely to be real differences in how far consumers trust their own supplier (with whom they have a direct relationship) compared with how much they trust suppliers in general. Consequently in assessing whether various aspects of trust are improving or worsening, it is essential to track the findings from the same question over time.

¹⁷ Ipsos MORI, Customer Engagement with the Energy Market - Tracking Survey 2013

¹⁸ Ipsos MORI, Customer Engagement with the Energy Market - Tracking Survey 2014

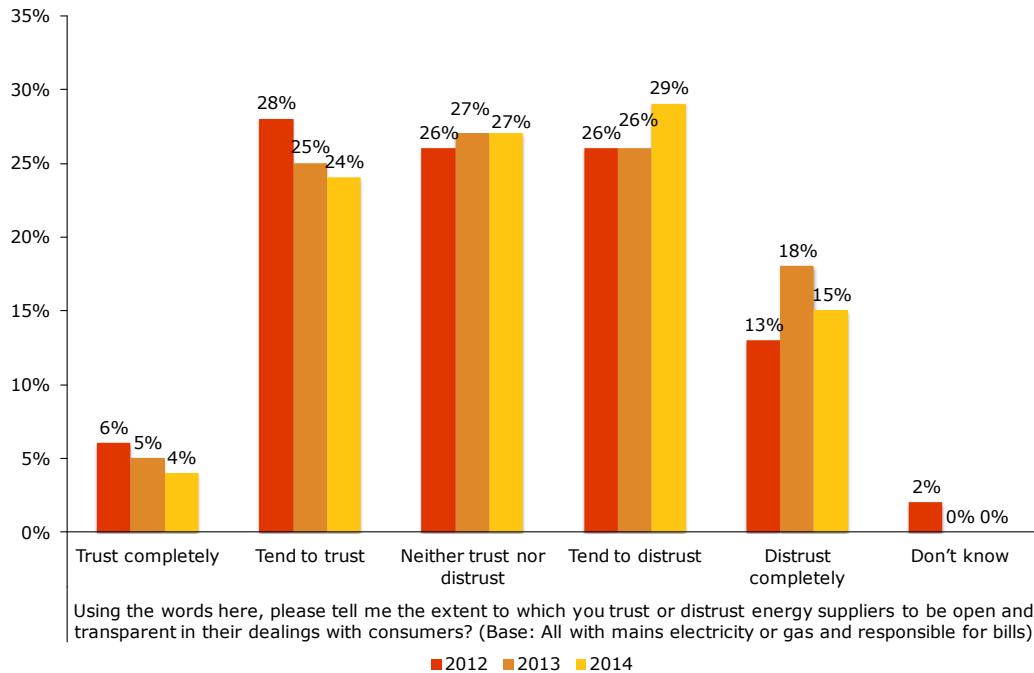
¹⁹ Ipsos MORI, Customer Engagement with the Energy Market- Tracking Survey 2014

²⁰ This was a statistically significant decline

²¹ EnergyUK, Consumer experience with the energy market, May 2014, pg.23-25, <http://www.energy-uk.org.uk/publication/finish/5-research-and-reports/1111-ipsos-mori-report-consumer-experiences-of-the-energy-market.html>

²² Ipsos MORI, Customer Engagement with the Energy Market - Tracking Survey 2013

FIGURE 3: TRUST IN SUPPLIERS



Source: 'Ipsos MORI, Customer Engagement with the Energy Market, Tracking Survey 2014'. Figures may not add to 100 per cent due to rounding.

Base: All with mains electricity or gas and responsible for bills; 2012 (base: 1484), 2013 (base: 1433), 2014 (base: 1393)

3.11. Consumers' concerns about switching are reflected in the high savings many say they would need in order to switch. When asked for a minimum saving necessary to induce them to switch, non-switchers who were able to give a figure reported a median amount of £99.²³ Twenty-six per cent of customers who have switched would not do so again.²⁴ In response, Ofgem is currently reforming and improving the switching process, for example by reducing the time taken to switch supplier to three days, plus the statutory two week cooling off period, by the end of 2014. We recently published a consultation setting out next steps and our ambition to move to next-day switching by the end of 2018 at the latest.²⁵

3.12. Our conclusion remains that weak customer engagement is a harmful feature of this market also takes into account that competition is more effective in some parts of the market than others. Consumers fall into different categories, with some being active in the market and others being disengaged. We also reached this conclusion based on the information on consumer switching that we presented in the assessment.

²³ Ipsos MORI, Customer Engagement with the Energy Market- Tracking Survey 2014

²⁴ Consumer Futures, Switched on? Consumer experience of energy switching, pg. 23,

<http://www.consumerfocus.org.uk/files/2013/01/Switched-on.pdf>

²⁵ Ofgem, 'Moving to reliable next-day switching', 16 June 2014

Questions for the CMA's investigation: does weak customer response harm competition in the retail market? If so, how can it be improved to make competition work better for all consumers?

Vertical integration

- 3.13. Vertical integration is an important feature of the electricity market. It could have many benefits, but could also be harming competition. We therefore think this key feature of the market warrants further investigation by the CMA. The six largest electricity suppliers directly own around 70 per cent of generation capacity and all but one (British Gas) own capacity equivalent to their domestic supply needs. This feature is less relevant to the gas market, which is less vertically integrated and where imports through pipelines and LNG terminals link the GB market to international commodity markets.
- 3.14. Vertical integration offers a natural hedge against volatile or changing wholesale prices and balancing risks; reducing risk and therefore potentially lowering consumers' prices. Suppliers' behaviour also suggests real benefits to vertical integration. All the large electricity suppliers are vertically integrated and some small suppliers have entered long-term supply contracts to achieve the same effect. Aggregate profits across generation and supply appear more stable than in either generation or supply alone, reflecting the natural hedge that vertical integration provides. All the largest six (vertically integrated) retail suppliers argued that the benefits of vertical integration outweigh the downsides.
- 3.15. Stakeholders have said that vertical integration also helps suppliers to lower their credit ratings, reducing requirements to post collateral to trade in wholesale markets. It may provide significant benefits by lowering companies' cost of capital, a significant saving for capital-intensive generation businesses. Lower investment costs could also improve investment prospects and so improve security of supply.
- 3.16. However, vertical integration also has potential costs. It can create barriers to entry in supply if new entrants face difficulties accessing wholesale products as a result, or face higher costs for the products they can purchase. Following our liquidity work, we have implemented remedies in the market targeting these concerns. Our remedies aim to increase wholesale liquidity and improve price formation, to improve independent generators' prospects for securing investment and allow independent suppliers to buy the wholesale products they need to compete. One industry group and two independent generators expressed concerns that vertical integration has considerable downsides, concurring with our conclusion that it can reduce the availability of wholesale market products and also contribute to less transparent wholesale market pricing. One respondent in particular noted that, in addition to the benefits we describe, vertical integration allows companies to avoid mark-to-market and collateral requirements through self-supply.
- 3.17. We also found in the assessment that vertical integration contributes to weak competitive dynamics between the largest suppliers. The advantages of having a balanced supply and generation portfolio (at least for domestic and small business customers) may increase the risks of taking a different retail strategy to their

competitors. The probe revealed that companies' business plans often set targets for customer numbers on this basis.

3.18. The balance between these costs and benefits in the electricity market is complex and difficult to analyse. However, we have reasonable grounds for suspecting that vertical integration is a feature of the market that has an adverse effect on competition, so warrants further investigation as part of the CMA's work. Those stakeholders that commented on this feature of the market generally welcomed our recommendation that the CMA should carry out a detailed investigation of whether vertical integration is in consumers' interests.

Questions for the CMA's investigation: is vertical integration in consumers' interests? Do its benefits outweigh its potential to harm competition?

Barriers to entry and expansion

3.19. In discussion with stakeholders and following consultation responses, we conclude that barriers to entry are a feature of the market that restrict competition; confirming what we identified in the probe. Two of the larger suppliers suggest that recent increases in smaller suppliers' aggregate market share show that barriers to entry and expansion are not insurmountable. However, most stakeholders recognised that barriers to entry remain and some said that they are increasing.

3.20. Barriers to entry include not just the effects of vertical integration discussed above, but also several other factors:

- **Credit and collateral costs.** Suppliers need to put up collateral to trade on wholesale markets and, separately, to sign up to industry codes. The Department of Energy and Climate Change's Electricity Market Reform will likely add further requirements. Some small suppliers told us that these requirements act as a barrier to expansion.²⁶ They also give an advantage to firms that have a strong credit rating.
- **Regulatory barriers and industry system requirements.** Energy supply is also a heavily regulated industry, in part reflecting its economic and social importance. Suppliers must comply with licence conditions and several industry codes. These costs apply to all businesses, but their complexity and scale burden small companies more, because they have lower revenue over which to spread those fixed costs. Smaller suppliers consequently often have less capacity for influencing changes made to these codes.

Certain government requirements for suppliers to fund social and environmental obligations act as a barrier to expansion. Small suppliers (with fewer than 250,000 domestic customer accounts) gain a cost advantage from being exempt from these obligations, but face a corresponding increase in costs if they grow beyond the threshold.

²⁶ As part of this assessment we have sought the views of stakeholders but have not performed a detailed review of these requirements.

- **Incumbent supplier pricing strategies.** We have consistently found that incumbent suppliers are able to target cheaper tariffs towards the most active consumers, making it more difficult for new entrants or small suppliers to win market share.
- **Reputational risks.** Some stakeholders that had considered entering the market said they were deterred, in part, by risks associated with political scrutiny and the poor reputation of the industry. Potential entrants were concerned that cross-industry systems could limit their level of control over customer service. Uncertainty surrounding future policy contributed further to stakeholders' concerns

3.21. Respondents to our consultation identified a range of barriers to entry, including industry credit and collateral arrangements and, more generally, complex regulation and the burden it creates. One consumer organisation and some large suppliers said that policy distorts the market, while other large suppliers and one small supplier focussed on the costs of complying with regulation and keeping up with new and changing rules. One small supplier and one large supplier noted that larger suppliers dominate industry-led processes, while other suppliers, small and large, and one generator think that RMR requirements stifle innovation. Others said that government's social and environmental schemes create barriers to expansion, because of the additional obligations biting once small suppliers reach 250,000 customer accounts.

Questions for the CMA's investigation: How and to what extent do barriers to entry and expansion harm competition? Can these barriers be reduced and, if so, how?

Continuing incumbency advantage and market segmentation

- 3.22. The probe and RMR found consumer harm resulting from suppliers' segmentation of the market. This is still happening. The six largest suppliers continue to have many customers who rarely or never engage in the market and generally charge higher prices to these customers. At the same time, these suppliers offer more competitive prices in other parts of the market, where customers tend to be more actively engaged. Some parts of the market exhibit even higher incumbent market shares, such as the market for dynamically-teleswitched tariffs.²⁷
- 3.23. All of the larger suppliers disagreed with our conclusion that incumbency advantage is a feature of the market and argued that incumbency does not harm competition. One of the larger suppliers suggested that there are costs associated with incumbency, such as those resulting from bad debt recovery, which should also be considered. However, small suppliers agree that incumbency allows larger suppliers to segment the market and to provide lower prices in some parts of the market.

²⁷ For example, in our 2013 report on the state of the market for customers with dynamically teleswitched 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.

- 3.24. Some stakeholders noted that segmentation occurs in other markets and is not always seen as harmful to competition or to consumers' interests. One stakeholder suggested that the burden of complicated regulation and processes can also lead to an incumbency advantage, because of economies of scale and the time and investment taken to understand them. These include, for example, the Smart Metering programme and EMR.
- 3.25. Some differences in price can be justified by differences in costs or in the products themselves. Those differences can also help to promote customer activity and engagement by providing an incentive to switch. This was outlined in an academic response to our consultation. Our conclusion is that many consumers have never participated in the more competitive parts of the market. This is a feature of the market that leads to some market power for suppliers, restricting the effect of competition on their prices.

Question for the CMA's investigation: does incumbency advantage harm competition? If so, how can this effect be mitigated to the benefit of all consumers?

Possible tacit coordination

- 3.26. In markets with stable competitive conditions, firms interacting repeatedly can sometimes establish a coordinated course of action without directly communicating with each other. This is known as tacit coordination. It results from individual firms acting independently and does not breach competition law, but can restrict competition and lead to higher prices, lower choice and less innovation.
- 3.27. In the probe and RMR, we found that many features of energy retail markets may facilitate tacit coordination. These are high concentration, similar product and cost structures across suppliers, observable pricing and relatively predictable demand conditions. The probe found that some suppliers matched hedging strategies and pricing with reference to a market leader. Barriers to entry and expansion contribute to the stability of these conditions, making it easier for suppliers to establish tacit coordination.
- 3.28. The assessment could not conclude whether tacit coordination exists. However, it did find evidence of possible tacit coordination in the energy supply market. Many aspects of price announcement behaviour among the largest suppliers are consistent with possible tacit coordination. They are winning customers more slowly, their price announcements tend to be more aligned and their profitability has shown signs of converging and increasing as prices rise more than costs. We also found evidence that large suppliers raise prices more quickly when costs increase than they reduce prices when costs fall. This evidence supports previous findings that many features of the retail energy markets may facilitate tacit coordination. Ofgem recently wrote to the largest suppliers, challenging them to explain to consumers the impact of falling wholesale prices on their retail prices.

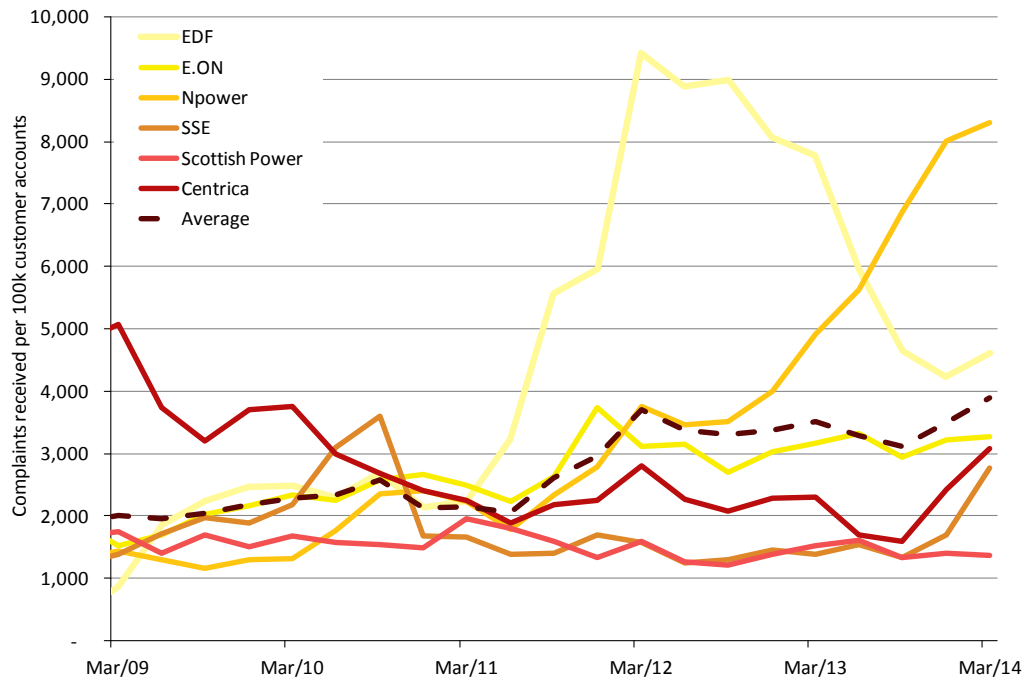
- 3.29. Some respondents agreed that there is evidence consistent with tacit coordination. Some stakeholders said that regulations have contributed towards the appearance of tacit coordination, such as publishing consolidated segmental statements and some licence requirements. But the largest six suppliers said that tacit coordination was not a feature of the market. As evidence for this, they outlined operational improvements as indications of continued competitive activity in the market. Taking these contrasting views into account, we do not think that stakeholders have presented sufficient evidence to alter our conclusion that there is a reasonable suspicion that tacit coordination is a feature of the market and that, if it is occurring, it potentially harms competition and consumers' interests.

Questions for the CMA's investigation: does tacit coordination exist? If so, does it harm competition and consumers' interest? What could be done to make competition work better?

Outcomes for consumers

- 3.30. Household consumer trust in the market remains low, after having declined significantly from 2012-2013 (as shown in the assessment). While comparisons between different surveys are difficult, there is little evidence of customers' trust in the market increasing. We see this particularly when comparing year-on-year results from the same survey.
- 3.31. The assessment also looked at levels of customer complaints, which doubled at the beginning of 2011 and then remained consistently high. The most recent data show complaints about the six largest suppliers increased in Q1 2014 by 12 per cent on the previous quarter, to their highest level in five years.

FIGURE 4: QUARTERLY COMPLAINTS RECEIVED PER 100K CUSTOMER ACCOUNTS



Source: Supplier Information

- 3.32. Supplier profitability can also indicate how effective competition is in the market. Several respondents noted the importance of profitability to consumers, particularly consumer representatives and one small supplier. The assessment concluded that the six largest suppliers' generation and non-domestic supply profits fell slightly from 2009 to 2012, but annual domestic supply profits increased from £233m to £1,190m. In the same period earnings before interest and tax increased as a percentage of sales for domestic supply of energy from 0.9 to 4.3 per cent. We also found signs that costs may not be efficient across the industry as a whole. These are indications that competition may not be effective throughout the market, but we have not been able to conclude whether profits are excessive.
- 3.33. More detailed analysis is needed to establish a firmer view. Further work would be needed to establish robust comparisons with other industries and countries, to develop alternative measures of profitability and to examine complex and diverse inter-company trading arrangements. Most of the largest suppliers support further work on profitability, as an opportunity to investigate further other relevant considerations, such as the profitability of different parts of the market, the relationship between profits in gas supply and electricity supply, and the relationship between profits and risk.
- 3.34. We also note that there has been limited innovation in the market. While there has been some innovation around tariffs there has been more limited innovation in terms of customer service. Suppliers have also been slow to move to smart metering. Some respondents, including large and small suppliers think that regulation and, in

particular RMR remedies, have contributed to this lack of innovation. Other respondents stress that innovation is multi-faceted, including quality and range of services, as well as types of tariff. We maintain that in a competitive market, suppliers would be under greater pressure to innovate than the assessment suggests is the case. 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.

Questions for the CMA's investigation: what do market outcomes say about the level of competition? What is the most appropriate measure of profitability? Are profits excessive?

Less problematic areas

- 3.35. The CMA is able to examine all areas of the market as set out in our terms of reference. In this section we set out some areas where we have not found evidence of significant competition problems.
- 3.36. Some stakeholders said in their consultation responses that the CMA should include transmission and distribution network regulation. These stakeholders suggested that network costs should be more transparent, while one said the CMA should consider whether ownership of networks by energy suppliers results in any distortion of competition. Two stakeholders said that the CMA should not include the role of networks in their investigation. Two stakeholders also wanted wholesale gas markets to be included in the CMA investigation and one suggested that upstream gas should also be included. One stakeholder thought that the CMA should investigate interconnection between Great Britain's gas and electricity networks and other networks, and gas storage and access. None suggested that the CMA investigation should include settlement reform.
- 3.37. We do not think these areas warrant specific investigation as part of a market investigation, for the reasons set out below:
- **Transmission and Distribution.** These are monopoly activities, with network companies subject to price regulation by Ofgem. Suppliers are not able to influence the costs of transmission and distribution, which are passed through to consumers. Suppliers are subject to network code regulations, and the effect of these on competition forms part of our market feature concerning barriers to entry and expansion.
 - **Interconnection and gas storage.** Our ongoing monitoring and our knowledge of the market have not revealed evidence of harmful market features in these areas, although both interconnection and gas storage play a role in wholesale markets.
 - **Wholesale gas markets.** The GB wholesale gas market does not possess the harmful features that we have identified in wholesale electricity. The market is much less vertically integrated and shows high levels of liquidity. Furthermore, the wholesale gas market in Great Britain is well connected

with other markets through import pipelines and LNG import terminals, making it part of a wider international market for gas.

Regulation

3.38. In the interests of consumers, Ofgem will continue work in a number of areas to address issues that we have already identified. We think the CMA should take these issues into account in its investigation of the market.

- **Third-party intermediaries.** These include switching sites, 'collective switching' (in the domestic market) and switching brokers (in the non-domestic market). Intermediaries can help consumers to get a better deal and promote competition but consumers need to know that they are getting high quality, independent advice. Intermediaries are governed by the Confidence Code²⁸; which requires members to uphold a code of practice. We recently proposed a similar code for non-domestic intermediaries alongside a consultation on collective switching.²⁹
- **Switching.** Ofgem is working to improve the speed and accuracy of the switching process, recognising that some consumers' concerns about lengthy or problematic switches can prevent them from doing so. Over 80 per cent of gas switches and 20 per cent of electricity switches take over five weeks. Even small error rates (currently one per cent of switches go wrong) affect large numbers of customers and can damage consumer confidence. On 16 June 2014 we approved proposals to cut switching times to three days (plus a statutory two week cooling off period).³⁰
- **Consumers in vulnerable situations.** We have been consulting with stakeholders and are working to promote face-to-face advice for vulnerable consumers. We recognise that they need additional support to engage in the market.
- **Transparency.** We are continuing work on the transparency of energy companies' profits aimed at helping to restore consumer confidence.

Smart meters and other retail developments

3.39. If the CMA implements remedies following its investigation, it will need to make those remedies appropriate and effective in a changing market. Smart metering, Electricity Market Reform and EU integration will all change the way the retail market operates. They could also have an impact on retail competition. Any arrangements the CMA put in place must therefore not just target problems in the market today, but also accommodate these future changes.

²⁸ Further information is available on the Ofgem website at: <https://www.ofgem.gov.uk/information-consumers/domestic-consumers/switching-your-energy-supplier/confidence-code>

²⁹ Ofgem, 'Protecting consumers in collective switching schemes', 10 February 2014

³⁰ <https://www.ofgem.gov.uk/news/faster-energy-switching>

Smart meters

- 3.40. Government is requiring suppliers, through licence obligations, to install smart meters in all homes and businesses by 2020. The main household rollout will begin in 2015, but some suppliers have started installing smart meters in homes. By December 2013 1.3 million homes already had a smart (or smart-type) meter.
- 3.41. Smart metering can give consumers better information and control over their energy use, in part through an in-home display to be given to all households. Smart metering also gives companies new opportunities to offer customers innovative products and services in the retail energy market, including 'time-of-use' variable pricing. Smart meters record usage more precisely over time (half-hourly) and provide two-way communication that could allow direct load control. Together, these capabilities provide many opportunities to increase consumer engagement in the energy retail market and will offer new opportunities for a more sustainable energy market delivering continued security of supply. Most parties interested in entering the retail energy market are looking to use smart metering to offer improved service quality.

Regulatory burden

- 3.42. Ofgem is continually working to ensure that barriers to entry in retail energy are as low as possible. We are examining the role of white labels and alternative models such as Ofgem's Licence Lite regime. These offer simpler entry routes than becoming a supplier and taking on complex activities such as balancing and settlement. Retail Market Review rules could reduce white labels' scope to offer tariffs different from their partner licensed supplier. We recognise the benefits of the white label model, so have provided an exemption until the end of 2014 while we consider the issue further.
- 3.43. In the assessment and our consultation we noted small suppliers' views that RMR may hinder innovation (both their own and generally in the market). A range of suppliers reiterated this point in their consultation responses. During our development of these remedies, we sought the right balance between simplification and allowing room for innovation. To preserve innovation, we allow scope for derogations to specific licence conditions. To prevent RMR tariff rules from creating undue barriers to entry or expansion, we will give priority to assessing whether this process allows for sufficient flexibility.
- 3.44. As part of a compliance review, we will aim to do more to help small suppliers understand the regulatory framework. DECC is also examining whether it could take measures to reduce barriers imposed by collateral and credit requirements.

Wholesale market developments

The government's Electricity Market Reform (EMR) proposals

- 3.45. EMR is a government programme of wholesale market reforms that aims to help deliver a secure, low-carbon and affordable electricity supply in future. The key elements of EMR are contracts for difference and a capacity mechanism. Contracts for difference are designed to support new investment in all forms of low-carbon generation. The capacity mechanism is there to provide incentives for investment in the overall level of reliable capacity needed to secure electricity supplies. The first capacity auctions will be at the end of 2014.
- 3.46. If the CMA investigates vertical integration, they will need to consider the impact of EMR on some of the benefits and costs of vertical integration. One generator noted this in their response. It thought that the capacity market could favour vertically integrated companies by allowing them to put lower bids into the capacity market auction.

European legislation

- 3.47. 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. This will have common rules to facilitate efficient use of cross-border capacity and to encourage harmonisation of European wholesale market arrangements.
- 3.48. 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.
- 3.49. There are also 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.

Appendices

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Appendix 1 – terms of reference

Terms of reference

The Gas and Electricity Markets Authority in exercise of its powers under sections 131 and 133 of the Enterprise Act 2002 (as provided for by section 36A of the Gas Act 1986 and section 43 of the Electricity Act 1989), hereby makes an ordinary reference to the chair of the Competition and Markets Authority for the constitution of a group under Schedule 4 to the Enterprise and Regulatory Reform Act 2013 for an investigation into the Supply and Acquisition of Energy in Great Britain.

The Gas and Electricity Markets Authority has reasonable grounds for suspecting that a feature or a combination of features of the market or markets for the Supply and Acquisition of Energy in Great Britain prevents, restricts or distorts competition.

For the purposes of this reference:

'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 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.

Appendix 2 – consultation responses

Summary of responses

We received 106 responses in total, 28 from organisations, energy companies and academics, and 78 from individual consumers. The 27 non-confidential responses are available on our website. All responses received from domestic consumers have been treated as confidential.

Non-confidential responses received

1. Queen’s University of Belfast	2. Eon
3. Centre for competition policy, University of East Anglia	4. ESB International
5. Centrica plc.	6. Federation of Small Businesses
7. CHP developer	8. First-Utility
9. Citizens Advice	10. GDF SUEZ Energy UK-Europe
11. Consultant	12. Good Energy
13. DONG Energy (UK) Ltd	14. InterGen
15. Drax	16. National Energy Action
17. Ecotricity	18. Opus Energy
19. EDF Energy	20. RES
21. Elexon Ltd	22. RWEnPower
23. Energy Intensive Users Group	24. Scottish Power
25. Energy UK	26. SSE
27. Which?	

Support for a reference and scope

All but one respondent expressed support for the proposal to make a reference to the CMA. Fourteen respondents agreed that an independent and objective review of the energy sector through the market investigation process would help clear the air and restore consumer confidence. Ten responses suggested that the process could be used to identify and address issues in the market, and nine responses thought that a market investigation would help improve investor certainty.

Not many respondents commented on the terms of references themselves, but instead put forward views on areas which should be included within the scope of an investigation by the CMA. Respondents suggested that areas should be considered by the CMA either to address perceived issues, or to clear the air and determine that there are no issues with that part of the arrangements.

The impact of regulation and the regulatory burden. The role of the regulator, and its impact on the market was something that eleven respondents suggested should be considered by the CMA. The burden that regulation creates was noted as something that impacts particularly on small suppliers.

Government social and environmental schemes. Seven respondents suggested that the design of government environmental and social schemes such as Energy Companies Obligation and Levy Exemption Certificates should be within the scope of a CMA investigation. Three respondents said that there should be more transparency about the delivery and costs of these schemes. Five stakeholders suggested that the small supplier exemption could create distortions to competition in the market, with two stakeholders questioning whether the advantage that the exemption confers upon small suppliers will be sustainable in the longer term. One respondent suggested that the larger incumbent suppliers have a monopsony in the LEC and ECO markets.

Networks. Seven respondents commented on whether network operators and their costs should be considered as part of the CMA's investigation. Two respondents said that network costs' should be taken into account by the CMA, and one respondent said there should be more transparency about network costs' impact on bills. Two stakeholders agreed that networks should not be within the scope of a CMA investigation as they are regulated monopolies and their costs are governed by Ofgem price controls. Two stakeholders suggested that the role of transmission and distribution network operators should be within scope of a CMA investigation, with one saying that the CMA should consider whether ownership of networks by energy suppliers results in any distortion of competition.

Third party intermediaries (TPIs). Six stakeholders think that the role, conduct and impact on competition of TPIs (such as brokers and switching sites) should be investigated by the CMA as part of a market investigation.

Ancillary services. Three respondents suggested that the impact on competition of ancillary energy services or 'bundled products' should be considered as part of an investigation, with one suggesting that bundled products act as a barrier to switching.

Metering. Three respondents suggested that the cost of metering and its impact on competition should be considered by the CMA.

The wholesale market. A number of respondents commented on whether wholesale market arrangements should be considered, beyond what is necessary for an investigation of vertical integration. Three respondents said there are no competition issues in the wholesale markets for gas and electricity. Four stakeholders suggested that the electricity generation market should be within scope of a CMA investigation, with two suggesting that barriers to entry for independent generators should be considered. One respondent suggested that electricity wholesale market transparency should be considered. Two respondents suggested that the gas wholesale market should be investigated, with one suggesting that there should be more transparency about the linkages between wholesale and retail gas. One respondent suggested that upstream gas should be included in any investigation. Two respondents suggested that barriers to decentralised generation should be considered by the CMA.

One stakeholder suggested that the CMA should also look at interconnectors, gas storage, on and off-shore trading arrangements, and upstream gas investments.

Market features

Weak consumer response

Eight respondents suggested that the assessment understates the level of consumer engagement in the retail energy market. Five respondents noted that switching levels had increased, particularly since the period analysed in the assessment. One respondent noted that while switching is increasing, it is still at half the rate that it was in 2010, while another suggested that switching is declining. A number of respondents commented on the use of switching data as a measure of consumer engagement, with two saying there was too much emphasis placed on switching between suppliers, as consumers can also switch between different tariffs with the same supplier. Three respondents suggested that low switching levels could be an indication of consumer satisfaction.

A number of barriers to switching were highlighted, including the speed of switching, supplier objections, product bundling and lack of consumer trust.

While fourteen respondents agreed a market investigation could help to restore consumer trust, two commented that the assessment understates levels of trust in the market. Three cited the results of a recent Ipsos MORI survey, which found that 48 per cent of those surveyed trusted their energy supplier. Two stakeholders noted that the questions asked in the Ipsos MORI were different to those from the survey cited in Ofgem's analysis, and that this may have contributed to the different results.

A number of respondents agreed that future developments such as smart meters and improved switching times would improve consumer engagement.

Possible tacit coordination

Nine respondents commented on whether there was possible non-collusive coordination between the six largest suppliers. All of the largest suppliers said that tacit coordination was not occurring, with two citing specific examples of operational improvements as evidence. Others suggest that tacit coordination may be harming competition.

There were suggestions that tacit coordination (or the appearance of it) may have been facilitated by regulation, such as requirements on Consolidated Segmental Statements and aspects of RMR. It was suggested that the CMA should consider whether there are reasons why companies might appear to be coordinated.

Vertical integration

Thirteen respondents welcomed the consideration of the pros and cons of vertical integration as a business model by the CMA. Eight respondents noted the efficiency benefits of vertical integration. Four respondents noted that vertical integration is only a concern in the context the high concentration. Of those that suggested that vertical integration can lead to low liquidity, three suggested that some form of structural remedy would be needed to address this, while one suggested that

targeted liquidity reforms are more appropriate. One stakeholder suggested that the CMA consider the robustness of segmental accounts, the reliability of wholesale prices and transparency of internal transactions.

Barriers to entry and expansion

Nine respondents highlighted the increasing share of the market held by small suppliers, with some arguing that this proves that barriers to entry are not insurmountable.

Respondents suggested a number of barriers to entry which should be considered by the CMA. Four respondents suggested that the industry credit and collateral arrangements should be considered. One respondent suggested that the credit and collateral arrangements were an important feature to protect consumers and the market. Seven respondents suggested that regulatory complexity and burden be considered, and five respondents suggested that government's social and environmental schemes be included as a relevant barrier.

Incumbency and segmentation

Eight respondents agreed that incumbency should be considered by the CMA, with three respondents suggesting that incumbency advantage may be leading to competition concerns, such as 'deep discounting' associated with segmentation, and incumbent dominance of industry processes such as EMR. One stakeholder noted that there are costs associated with incumbency, such as debt recovery, which should also be considered by the CMA. Several respondents noted that the increasing market share of small suppliers means that incumbency is no longer a feature of the market. Two stakeholders suggested that price segmentation is not generally seen as harmful and occurs in other markets.

Business consumers

No stakeholders objected to the inclusion of small business consumers in the scope of our proposed reference. Two stakeholders suggested that the text of the terms of reference may need to change to prevent some larger business consumers from being included within the scope of the proposed reference.

Three stakeholders thought that larger non-domestic consumers should be included in the scope of the reference and should be considered by the CMA to some extent.

The Federation of Small Businesses presented the results of a survey of their members, suggesting there are low levels of trust and engagement in the small business sector. They suggest a number of problems that small businesses face: a lack of experience in purchasing energy; high opportunity cost and low benefits of time spent making purchasing decisions; and poor bargaining power.

Profitability

Seven respondents welcomed further study of profits, principally in order to 'clear the air' and establish reasonable levels of profit. One respondent suggested that the following be considered by the CMA: levels of profitability in the context of risks; profits by customer segment; the interaction between profits in electricity and gas; and the role of scale contributing to higher profits. One respondent noted that supplier margins are increasing, and suggested that suppliers pass through cost increases more readily than cost decreases.

Investor certainty and a reference

Many of the responses note the existing political and regulatory uncertainty and its impact on investor risk, but only one suggested that a reference would increase this uncertainty.

Nevertheless, there were a number of suggestions for ensuring investor confidence throughout a market investigation, including clear and early communication of the CMA's scope and findings, as well as a swift market investigation process.

Ongoing regulatory developments

Most responses suggested that it will be important for the CMA to take account of recent and ongoing market developments such as EMR, RMR, Smart Meter rollout and European integration.

Eight respondents suggested that elements of RMR, in particular the tariff cap, should be considered by the CMA.

Some stakeholders suggested that elements of Ofgem's liquidity proposals should be in scope, with three respondents suggesting a structural remedy may be needed to improve liquidity.

Most stakeholders who commented on EMR noted that it was an important future development which would be important for the CMA to consider as part of its investigation, but only two stakeholders suggested that the design of EMR itself should be investigated. One stakeholder commented on the Contract for Difference Supplier Obligation, noting that a variable rate obligation for suppliers could increase independent suppliers' risk premia. Another respondent suggested that the CMA should consider whether the structure of the proposed capacity mechanism might inhibit new entry by independent CCGT developers.

Individual consumer responses

We received a total of 78 responses from individual consumers, 72 of which were prompted by the Money Saving Expert's "What would it take for you to trust your energy firm?" campaign. A number of different themes arose from the responses.

Handling monthly direct payments: Accounts in credit were one of the main sources of distrust. Some of the most common experiences cited were suppliers taking too long to receive a finalised bill and refund when an account is in credit (when closing

account, switching, moving home, etc.), and difficulties in making changes to adjust monthly payments. Some consumers speculated that their suppliers were intentionally adjusting their payments to keep their accounts in credit in order to benefit financially (earn interest). Suggestions were given to address the issue by requiring suppliers to balance accounts annually or twice a year.

Customer service: A number of customers found that resolving issues raised to the customer service departments of the energy suppliers was taking too long.

Switching: Respondents who had switched were concerned about the time it takes to switch and were uncertain about whether they were getting a good deal.

Bill complexity: A number of respondents felt bills are difficult to understand and compare across suppliers. A common suggestion by those customers was to have a single per unit price on bills to make them easy to compare.

Another suggestion on tariffs was to move existing customers to the cheapest available tariff automatically. This respondent found it time consuming and difficult to be frequently checking whether they were getting a good deal.

Some of the respondents made more general observations of the energy industry. A common point raised was that it is not clear how wholesale costs are reflected on retail prices. Some respondents saw vertical integration as the key cause of insufficient market competition and a major source of market power for the large integrated energy suppliers.

Some respondents expressed very positive views of their suppliers. They found they could trust their providers to treat them fairly, deliver value for money and professional customer care.

Appendix 3 - Feedback Questionnaire

Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

- 1. Do you have any comments about the overall process, which was adopted for this consultation?**
- 2. Do you have any comments about the overall tone and content of the report?**
- 3. Was the report easy to read and understand, could it have been better written?**
- 4. To what extent did the report's conclusions provide a balanced view?**
- 5. To what extent did the report make reasoned recommendations for improvement?**
- 6. Please add any further comments?**

Please send your comments to:

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