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Report

Outcome of 2022 review into whether conditions are in place for effective competition in domestic supply contracts

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This report sets out the outcome of our third review into whether conditions are in place for effective competition in domestic supply contracts. It includes our recommendation on whether the default tariff cap should be extended to the end of 2023. Our analysis follows the assessment framework that we published in October 2019 and provides an update on progress made since the second annual review, published in August 2021.

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Executive Summary

This is a report on the outcome of our 2022 review into whether competition in domestic supply contracts would be effective in protecting consumers in the absence of the price cap, carried out in accordance with legislative requirements under Section 7 of the Domestic Gas and Electricity (Tariff Cap) Act 2018.

Background and key findings

Conditions in the UK domestic retail energy market have changed dramatically over the last year. A combination of factors has led to unprecedented increases in both the level and volatility of wholesale gas prices. This in turn resulted in a wave of exits by suppliers, many of which were revealed as having unsustainable business models, with 24 companies exiting the market in the second half of 2021. The Russian invasion of Ukraine in February 2022 exacerbated this situation further and removed the possibility of a relatively quick return to more normal conditions. These events have occurred as part of a wider cost of living crisis, which increases the need to ensure that customers are protected against excessive pricing. It has also led to a far greater focus on the level of consumer bills and on the energy market than has been seen in the past.

Within the analysis for this report, we have considered how the conditions for effective competition have been affected by these events, as well as by other developments over the course of the past year. In some areas, we have added new indicators to maintain the effectiveness of the analysis, given that the crisis has made certain metrics (such as switching rates) less relevant than before. Our review has found that the competitive process would not adequately protect consumers in the absence of the cap, and therefore our recommendation is to retain the cap until the end of 2023.

Under the current legislation, this is the final review to be carried out in relation to the price cap. However, the Government's Energy Security Bill will enable the extension of the price cap beyond 2023, when the provisions of the current Act expire.

Condition 1: structural changes from the government, Ofgem and the wider market are facilitating competition.

Government/Ofgem

The legislative and regulatory environment of the market is evolving in a number of ways. The Government's smart meter rollout has been reinforced by the new delivery framework setting annual installation targets, while Ofgem has published the governance arrangements for Market-wide Half Hourly Settlement (MHHS) and placed regulatory obligations on market participants to implement MHHS by the end of 2025, to enable the full benefits of smart metering. As of now, however, the smart meter rollout has not progressed sufficiently to have a material impact on competition.

The Faster and More Reliable Switching Programme went live in July 2022, and we expect this to improve consumers' experiences of switching and to facilitate engagement. However, it is too early to assess its impact on competition.

Ofgem is also now engaged in work to strengthen financial resilience within the market. We are considering a range of measures, including the introduction of specific capital adequacy requirements, to enable a more resilient market that will improve consumer outcomes.

Wider Market

Ownership of plug-in electric vehicles (EVs) is rising rapidly and should start to drive greater engagement with the market from those owners that are looking for Time of Use tariffs that allow cheaper overnight charging. At present, however, overall numbers of plug-in EVs are not yet large enough to impact competition.

Given the evolving nature of these structural changes, and the uncertainties around their impacts, we conclude that Condition 1 is not yet met.

Condition 2: The competitive process should be expected to work well in the absence of the default tariff cap.

Consumer engagement with the market

While supplier switching levels dropped by over 80% due to the lack of price competition in the wake of rising wholesale costs, survey data suggests that substantial numbers of

consumers remained engaged by searching for better deals. Prior to this, however, the data indicated that around 25% of consumers continued to show little or no engagement with the market. Currently, we do not see any evidence that removing the cap would not lead to unfair pricing for such consumers.

Market structure

Inevitably, the exit of multiple suppliers in the second half (H2) of 2021 has resulted in an increase in market concentration. The number of active suppliers fell by 50% during 2021, from 52 to 26, and the combined market share of large suppliers in the electricity market increased from 81% to 91%. The exit of many smaller suppliers has also resulted in a substantial increase in the proportion of consumers who say they would only consider switching to a large or well-known supplier.[1]

Overall, we conclude that Condition 2 is not yet met.

Condition 3: Competition is delivering fair outcomes for consumers

Consumers are not benefitting from competition at present, due to the limited choice driven by volatility in the wholesale market. Standard variable tariffs (SVTs) across the market have converged on the cap level and are also now universally cheaper than fixed tariffs. Supplier exits and market volatility have reduced the number of tariffs available by over 60%, so reducing customer choice.

On quality of service, overall customer satisfaction has been falling since Q2 2020, and is now at its lowest level since 2018. Satisfaction fell across all categories of supplier, but most steeply for medium suppliers. Lengthening call waiting times are a particular area of concern, given that recent events have made it more important than ever for consumers to be able to contact their supplier.

Overall, we conclude that Condition 3 is not yet met.

[1] Ofgem and Citizens Advice, Consumer Perceptions of the Energy Market Q1 2022 (fieldwork conducted in March 2022)

Next steps

In light of the recent findings by Oxera and the National Audit Office (NAO) relating to the regulation of the supplier market, we intend to review the framework for assessing competition. This will also consider the impact of recent changes to the cap and those announced alongside this report.

In addition, we will consider how we may need to update or reform the price cap to ensure continued price protection as the retail market changes, for example with the introduction of mandatory half hourly settlement in 2025, and the need to support the adoption of flexible pricing for the growing number of electric vehicles on the system. This may be through either an updated form of the price cap, or an alternative form of price protection, if this would be more appropriate. Any such price protection will need to promote tariff structures that encourage consumer flexibility as an essential component of a net-zero energy system.

1. Introduction

Context and related publications

1.1. The Domestic Gas and Electricity (Tariff Cap) Act 2018, hereafter the "Tariff Cap Act",[2] required us to put a price cap on default and standard variable tariffs. This was due to widespread concern that the market was not working as well as it should for consumers on these tariffs, who were typically less engaged with the market and the products it offers. In particular, there was concern that these consumers were being overcharged for their energy supply.[3]

1.2. The default tariff cap is currently in place until the end of 2022. Section 7 of the Tariff Cap Act requires Ofgem to review whether conditions are in place for effective competition in the domestic retail market and make a recommendation on whether to extend the default tariff cap to the end of 2023. We must publish a report on the outcome of this review, including our recommendation, by 31 August 2022. The Secretary of State will consider it and make a decision by 31 October 2022. Under current legislation, the default tariff cap cannot be extended beyond 2023. However, the government's Energy Security Bill (introduced on 6 July 2022) will enable the extension of the price cap beyond 2023.[4]

1.3. The current report is the outcome of our 2022 review. It builds on last year's review,[5] focusing in particular on how the market has evolved over the past year and how we may expect it to evolve in future.

Recent market developments

1.4. The past year has seen unprecedented levels of disruption in the GB energy markets. Starting in the summer of 2021, wholesale gas prices began rising rapidly, going from 64p/therm in early August 2021 to as much as 270p/therm in December 2021. This was due to a number of factors, including Russia's curtailment of supply

[2] Domestic Gas and Electricity (Tariff Cap) Act 2018
[3] For example, see para 160 of CMA (2016), "Energy market investigation: Final report".
[4] BEIS: Energy Security Bill
[5] Ofgem: "Outcome of 2021 review into whether conditions are in place for effective competition in domestic supply contracts"

to Europe and a rise in demand from Asia as countries recovered from the downturn caused by Covid-19.

1.5. The resulting rise in domestic retail prices was limited by the default tariff price cap, which put pressure on those suppliers that had not adequately hedged their exposure against a wholesale price increase of this scale, and lacked the financial resilience to deal with it. Consequently, there were multiple supplier failures during the autumn of 2021, with 24 companies in total exiting the market during the second half of the year. Almost 2.4m customers were transferred to new suppliers under the SoLR process,[6] while the Special Administration Regime (SAR) was used for the first time to deal with one supplier that was too large to handle under SoLR.

1.6. A further consequence was that price competition largely disappeared from the market, as all SVTs converged on the price cap, while the price of fixed tariffs rose well above this. Therefore, in addition to those customers that were automatically moved on to a default tariff through a SoLR process, many others chose to switch to an SVT as the prices of fixed tariff deals rose rapidly above the price cap.

1.7. The Russian invasion of Ukraine in February 2022 exacerbated this situation further, and wholesale prices reached a fresh high of 314p/therm in March 2022[7]. The rise in prices then fed through to the price cap in April, with the latter increasing by over 50%. These events have contributed to a wider cost of living crisis in the UK that has seen inflation rise to 9.4% in June.

1.8. In response to these events, Ofgem has introduced a number of short-term measures to protect consumers and stabilise the market. These include:

- an obligation on suppliers to make all tariffs available to existing customers as well as new ones; and
- a Market Stabilisation Charge, under which suppliers that gain customers must pay a fee to the previous supplier if the wholesale price subsequently falls below a certain level.

[6] Ofgem: "Check who's taken over your energy supply"
[7] Ofgem: Wholesale Market Indicators

1.9. These two measures are necessary to mitigate the risks of supplier failures if wholesale energy prices fall back towards historic levels. They enable suppliers to continue to work within the boundaries of the price cap to manage the procurement of energy on behalf of consumers

1.10. Ofgem has also proposed a set of changes to the setting of the price cap, as follows:

- the price cap level will change every 3 months, instead of 6;
- the notice period before each change in the price cap will be shortened;
- the calculation will be adjusted to allow for the recovery of backwardation charges in a reasonable period of time.[8]

1.11. These changes will be accompanied by a set of measures being developed by Ofgem to strengthen financial resilience in the market. This will include steps to reduce mutualisation costs and ringfence consumer credit balances. We are also considering the introduction of specific capital adequacy requirements.

Overview of our decision framework

1.12. The review that we have undertaken follows the analytical decision framework that we developed, through consultation, in 2019.[9] As illustrated in Figure 1 below, the framework consists of a definition of effective competition[10] and three conditions for effective competition. While the conditions may be satisfied individually to differing degrees, we will assess whether they have been met collectively.

[8] Backwardation is when the current price of an underlying asset is higher than prices trading in the futures market.
[9] Ofgem (2019) "Decision – Framework for assessing whether conditions are in place for effective competition in domestic supply contracts".
[10] The Tariff Cap Act does not define effective competition, nor is there a generally accepted definition in relevant policy frameworks or academic literature. For our decision framework, we therefore developed a definition. Our definition and related conditions should be viewed within the context of the requirements under the Tariff Cap Act.

Figure 1: Overview of the conditions for effective competition

Definition of effective competition

We will consider competition to be effective if there are no significant barriers to consumers being able to access, assess and act on information about the products and services they may want, driving rivalry between firms to win and retain customers.

Consumers should get fair outcomes in terms of what matters to them, including not being overcharged from either firms making excessive profits or passing on inefficient costs, having access to a reasonable range of tariffs to meet different needs, receiving a good quality of service and being able to transfer quickly and reliably.

The Conditions for effective competition

Condition 1: Structural changes are facilitating competition.
Structural changes are facilitating or can be expected to facilitate the competitive process. These structural changes include those from the government, Ofgem, and the wider market.

Condition 2: Well-functioning competitive process.
The competitive process in the domestic retail energy market should be expected to work well in the absence of the cap.

Condition 3: Fair outcomes for consumers.
The competitive process should be expected to deliver fair outcomes for consumers in terms of what matters to them. For example, this includes not being overcharged due to prices being set high for excessive profits and/or due to inefficient costs being passed on.

Our recommendation

1.13. Our conclusion is that the conditions for effective competition are not yet in place and we recommend extending the default tariff cap to the end of 2023. Our analysis supporting this is set out in the remainder of this report:

- in Chapter 2, we assess progress in implementing structural changes to facilitate competition (Condition 1 from our decision framework).
- in Chapter 3, we assess how the competitive process may be expected to work in absence of the default tariff cap (Condition 2 from our decision framework).
- in Chapter 4, we assess whether competition can be expected to deliver fair outcomes for consumers (Condition 3 from our decision framework).

Your feedback

We believe that feedback is at the heart of good policy development. We are keen to receive your comments about this report. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall process of this report?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Are its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

Please send any general feedback comments to EffectiveCompetition@ofgem.gov.uk

2. Assessing Condition 1: Structural changes should facilitate competition

Chapter summary

In this chapter, we set out our view that **Condition 1 is not yet met**. We find that:

- a number of long-term programmes – including the smart meter rollout and the implementation of Market-wide Half Hourly Settlement – continue to make progress but will not have a meaningful influence on the market in the near future.
- the Faster and More Reliable Switching Programme went live in July 2022, so we will need to monitor its impact before drawing conclusions on its effect on competition.
- market events have demonstrated a lack of supplier resilience, and Ofgem is considering a range of measures to strengthen this.
- rising ownership of plug-in electric vehicles has the potential to support consumer engagement in future, but further growth is required first.
- it remains to be seen whether price comparison websites (PCWs) will be able to play the same role as before once price competition returns to the market.

2.1. Our first condition is that structural changes from the government, Ofgem and the wider market should facilitate competition. Examples of these could be regulatory changes, technological developments or the emergence of new services that help consumers engage with the market. Each of the structural changes that we consider has a bearing on how well competition works, for example through allowing consumers to better understand their energy use and make informed choices, enabling them to act on these choices through a swift and reliable switching process, or ensuring suppliers are financially prepared to meet their commitments.

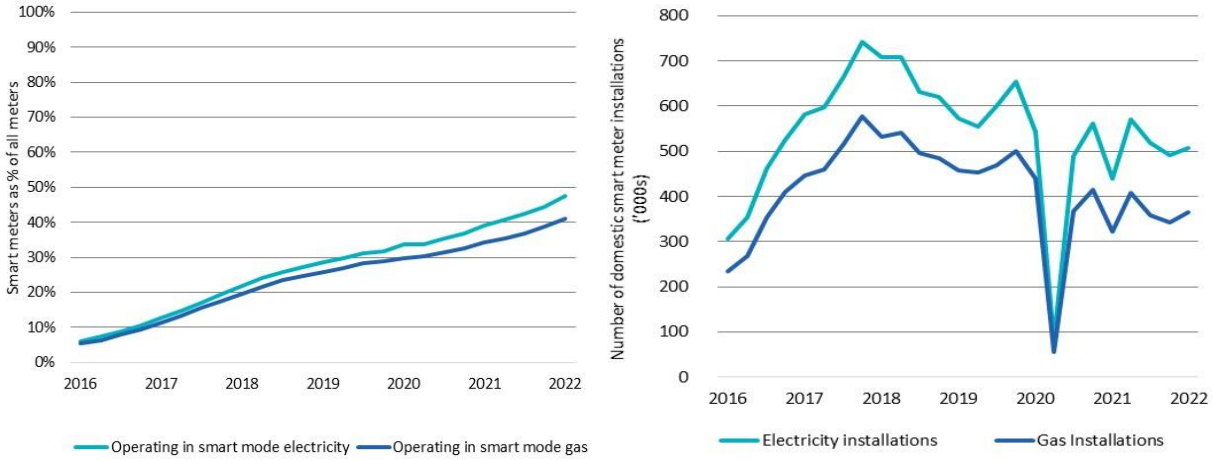
Structural changes from government

The smart meter rollout continues to make progress

2.2. Smart meters should facilitate the competitive process through giving consumers both real time and historic data on their energy use, allowing them to make more informed choices.

2.3. At the end of Q1 2022, 51% of households had smart meters for electricity and 47% for gas, up from 48% and 44% 12 months previously[11]. In 2021, smart meter installations were higher than in 2020 but still remained below pre-Covid levels. From January 2022, a new four-year framework with annual installation targets for suppliers was implemented, with suppliers being required to publish their progress. All gas and electricity suppliers now have binding annual installation targets to roll out smart meters to their remaining customers by the end of 2025.[12]

Figure 2: Proportion of smart meters and number of installations



Source: BEIS (2022) Q1 2022 Smart Meters Statistics Report (publishing.service.gov.uk)
Notes: This figure contains data for suppliers classified by BEIS as "large": these constitute the vast majority of smart installations and provide data quarterly. As of Q4 2021, these were British Gas, Bulb, E.ON; EDF Energy; Octopus; Opus; OVO; Shell; Scottish Power; So Energy; SSE; Utilita; Utility Warehouse

Structural changes from Ofgem

Structural changes pre price shock

2.4. Prior to the price shock and subsequent market disruption in H2 2021, Ofgem was already in the process of bringing forward a number of structural changes. Since then, we have also been developing further measures to address the issues that have emerged.

[11] It should be noted that around a tenth of installed smart meters are first generation (SMETS1) meters that have temporarily lost their smart capabilities following transfer to a new supplier.
[12] Ofgem (2022): Supplier Smart Metering Installation Targets

Market-wide Half Hourly Settlement should, in time, improve retail market competitiveness

2.5. As smart meters can record energy consumption every half-hour, they are capable of enabling half-hourly settlement. Market-wide Half Hourly Settlement (MHHS) means suppliers will face the true costs of serving their customers. This will incentivise the development of new products (including tariffs) and services which reward customers for shifting their consumption to times when electricity is cheaper to generate and transport, so improving the efficiency of domestic electricity supply. At present, the MHHS Implementation Manager is conducting a timetable replan exercise. The aim of the replan is to draw up a credible, robust and achievable plan that sees MHHS implemented at the earliest possible date and preferably no later than the current completion date of October 2025.

Our Faster and More Reliable Switching Programme measures should improve consumers' experience of switching and facilitate engagement

2.6. Accurate and timely switching should facilitate market engagement by allowing consumers to switch with confidence, quickly and without disruption. Following several years of development, the Faster and More Reliable Switching Programme went live on 18 July 2022, introducing a new, flexible, centralised service for gas and electricity switches which can respond to the significant changes already underway in the energy market. We will monitor the impact of this programme over the coming years.

Structural changes post price shock

2.7. We have published a series of consultations[13] with proposals to strengthen retail financial resilience, including proposals to reduce mutualisation costs and to protect consumer credit balances and the revenues collected to fund Renewables Obligations.

2.8. We are also considering the introduction of specific capital adequacy requirements, and approaches to reduce costs associated with hedging when suppliers fail. These proposals seek to ensure that suppliers bear the appropriate cost of the risk-taking

[13] Ofgem (2022): Policy Consultation: Strengthening Financial Resilience

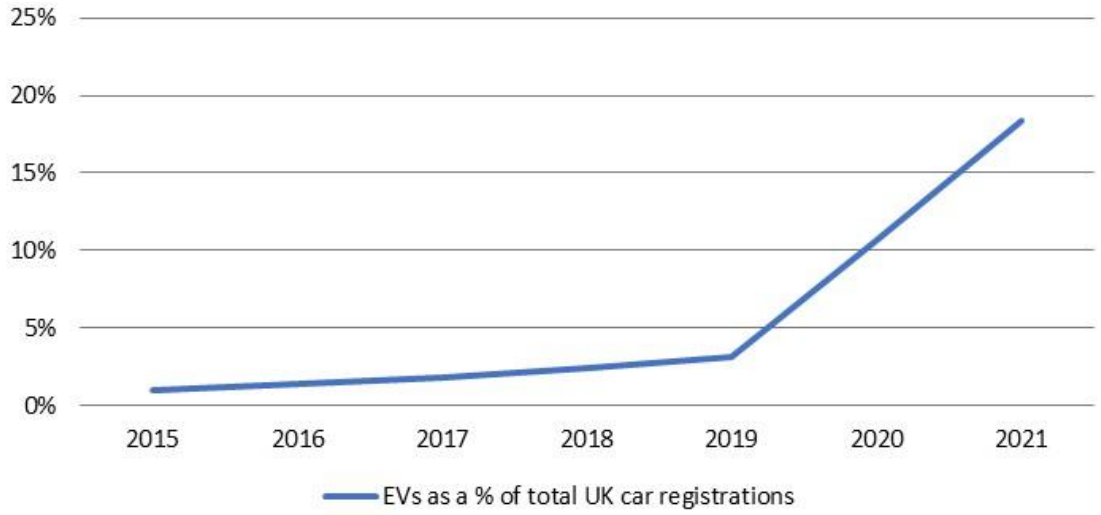
so that they are more resilient to market shocks, and that customers are shielded from the impacts of supplier failures as far as possible. As such, they should strengthen the market position of efficient suppliers and improve rivalry between suppliers with sustainable business models.

Structural changes in the wider market

Electric vehicle (EV) ownership is growing fast

2.9. Levels of plug-in EV ownership are rising in GB. We consider this to be a structural shift with the potential to generate greater consumer engagement in the market, as it offers owners the opportunity to make substantial savings by switching to an EV tariff and charging the vehicles at lower night-time rates.

Figure 3: Plug-in EV share of UK car registrations



Source: Vehicle licensing statistics data tables - GOV.UK (www.gov.uk)

2.10. Since 2019, the plug-in EV share of the new car market has grown rapidly. It is too early to assess how this may translate to consumer engagement, but we will continue to monitor this.

Price Comparison Websites are currently unable to provide the same service as before

2.11. Platforms such as price comparison websites (PCWs) and automatic switching services help consumers engage with the market through different channels. PCWs have historically been the most commonly known and used method of switching and comparing. Currently, the lack of price competition in the market following the

wholesale price shock means that PCWs currently have little to offer consumers, and as a result some of these sites have temporarily ceased to deal with energy. While we expect that the absent PCWs will return to the market once price competition re-emerges, it remains to be seen whether future retail margins and supplier business models will allow PCWs to play the same role in the market as before.

Overall conclusion: Condition 1 is not yet met.

2.12. There has been significant progress made on structural changes to promote competition, with the completion of the Faster & More Reliable Switching Programme, and new frameworks for the delivery of the smart meter programme and MHHS. The benefits of these, however, will still take some time to materialise fully. In addition, the price shock and subsequent market exits have required a reappraisal of market regulations, and we will not be in a position to judge the impact of these until they have been finalised and implemented.

3. Assessing condition 2: A well-functioning competitive process

Chapter summary

In this chapter, we set out our view that **Condition 2 is not yet met**. We find that:

- we have not seen evidence to suggest any change to our conclusion in previous years that a substantial proportion of consumers remain disengaged from the market.
- the market disruption since August 2021 created significant uncertainty around the direction of consumer engagement and we do not yet have reliable evidence on whether this has affected existing long-term trends.
- market concentration is rising due to the exit of many smaller suppliers, though this has not changed our overall assessment of it.

3.1. As set out in our decision framework, there are three parts to our assessment of the competitive process: we assess (1) the evolution of consumer engagement and any barriers to engagement, (2) market structure and competitive dynamics and (3) supplier performance including commercial opportunity.

Consumer behaviour

3.2. Consumer engagement is central to driving competition between market providers to win and retain consumers. The higher the level of consumer engagement, the more responsive consumers are to the prices suppliers charge and the quality of service they provide. This places a restraint on price-setting behaviour and incentivises good customer service.

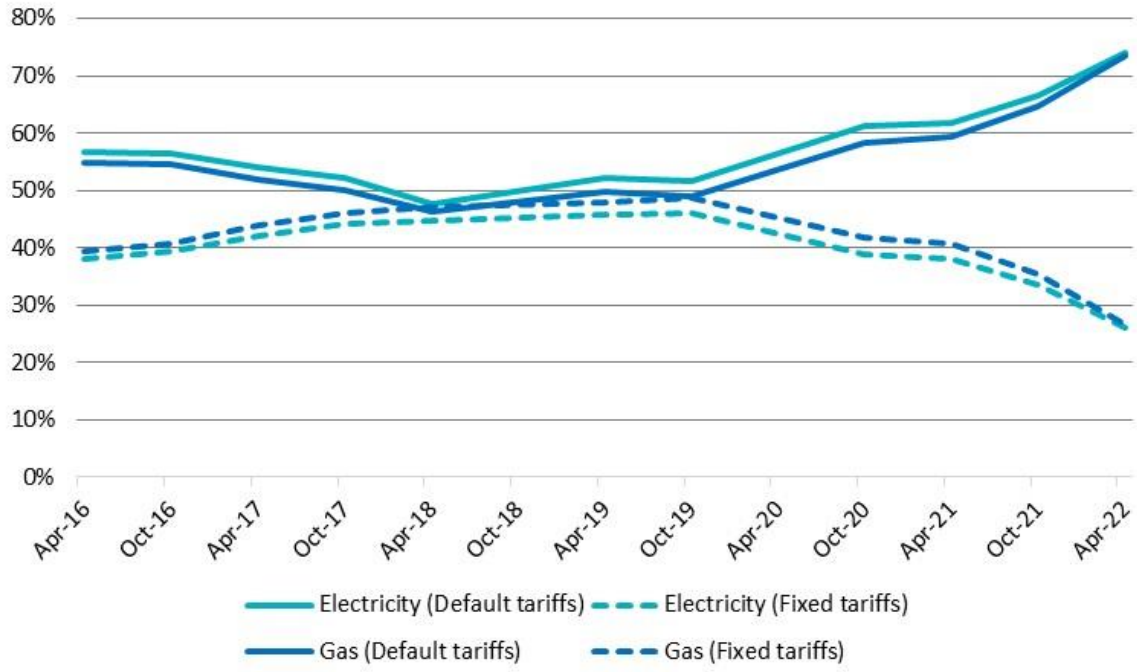
3.3. Market events since the onset of sustained high gas prices in August 2021 have significantly affected some of the indicators we use to measure engagement. From that time on, as SVTs from all suppliers converged around the price cap and the cost of fixed tariffs increased well above this, switching between suppliers dropped markedly, while many customers moved from fixed tariffs to SVTs due to either supplier failure or their deal ending and the SVT now being the cheapest offering.

3.4. To gain a more rounded view, we have looked at both the long term trends in engagement in the period before the price rises, as well as the subsequent impacts.

Long term trends for engagement

3.5. Prior to August 2021, a substantial majority of customers were on default tariffs, though this figure has fluctuated since 2016 (see Figure 4). Since these were the most expensive tariffs on the market at that point, we consider that a good measure of engagement is the proportion of people that have taken action to reduce their energy bills by moving to a cheaper option. This indicates that the market in mid-2021 was divided between around 40% of customers that have switched to a fixed tariff, compared to around 60% that have not.

Figure 4: Percentage of consumers on default and fixed tariffs

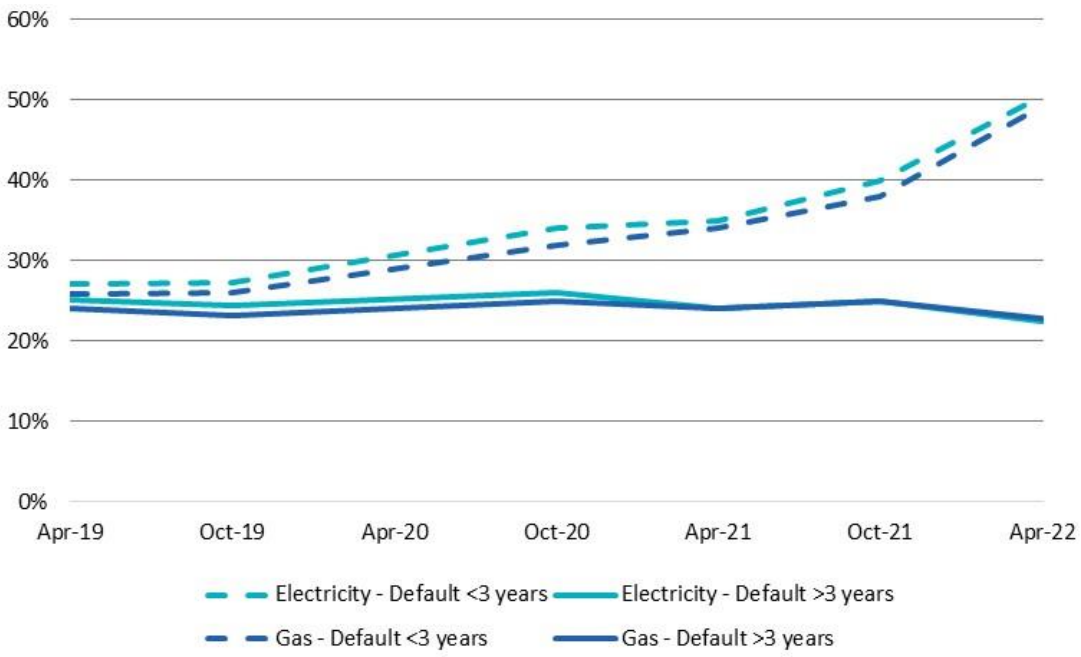


Source: Ofgem Price Cap Accounts

3.6. However, a smaller number – around 25% of consumers – have been on a default tariff for over 3 years, which is a stronger indicator of disengagement. This figure has stayed constant between 2019 and the start of the price shock (see Figure 5). While it is not clear why this specific segment of consumers have not chosen to

switch, our 2021 Consumer Survey[14] highlights that the top perceived risks that consumers associate with switching are that they might not save as much as they thought and that costs might go up.

Figure 5: Percentage of consumers on default tariffs for more and less than 3 years

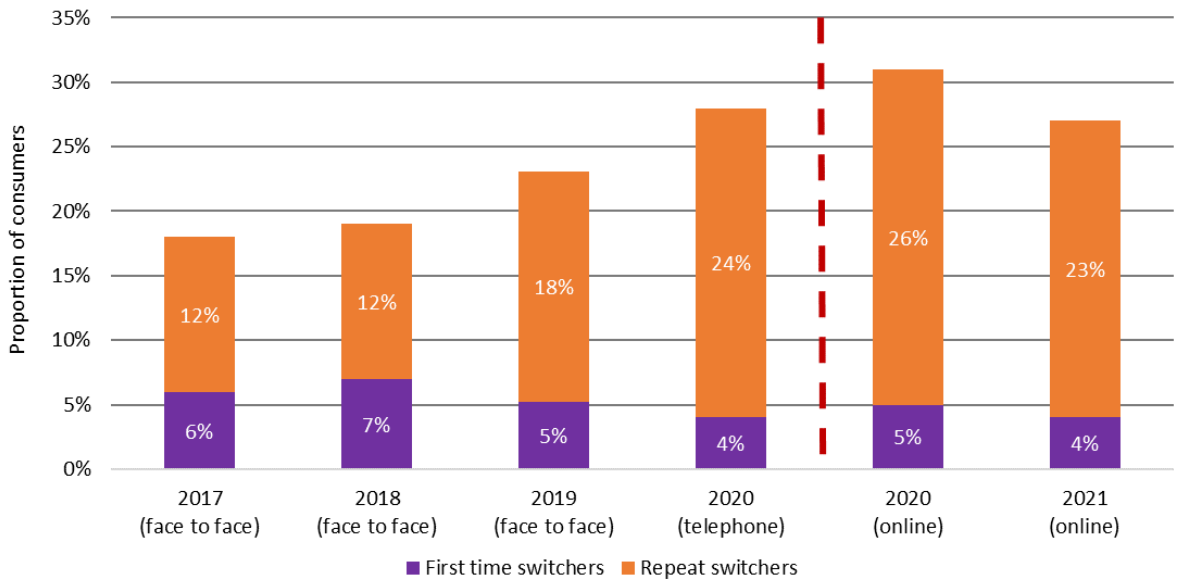


Source: Ofgem Price Cap Accounts

3.7. Looking at the trends in switching over time, Figure 6 shows that the percentage of first time switchers has remained largely unchanged with a slight decrease since 2018. This suggests slow progress in getting previously unengaged customers to become involved in the market for the first time through switching.

[14] Ofgem annual Consumer Surveys and Consumer Impact of Market Conditions survey

Figure 6: Annual percentage of consumers switching, by previous activity

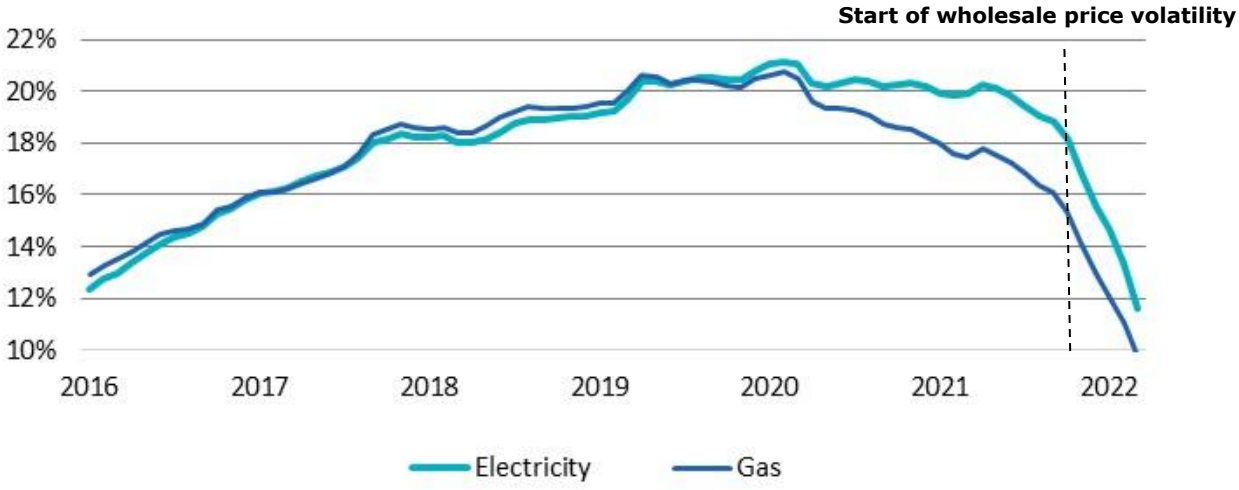


Source: Ofgem, Consumer Survey 2017-2021 (fieldwork conducted in August-September 2017-2021)
Notes: The 2020 and 2021 figures are not directly comparable with previous years because the main survey method changed from face-to-face to an online survey. Consumers who answer online surveys tend to be more engaged with the market and inclined to switch energy deals. They also show greater confidence in their ability to select an energy deal. In 2020, an additional parallel run of the 2020 survey was conducted over the telephone with a smaller sample. The results from the online and telephone surveys are both shown for 2020, as the telephone results are more comparable to the previous face-to-face-surveys, while the online results are more comparable to 2021's online-only survey.

The wholesale price shock has meant that it is difficult to compare recent changes in engagement with previous trends

3.8. In previous reviews, we have used switching as an indicator for consumer engagement. However, as noted in paragraphs 1.5 and 1.6, the rise in wholesale prices above the allowance in the price cap set in August 2021 reduced price competition in the market, and the subsequent fall in switching levels (see Figure 7) primarily reflects this rather than providing an indication of engagement.

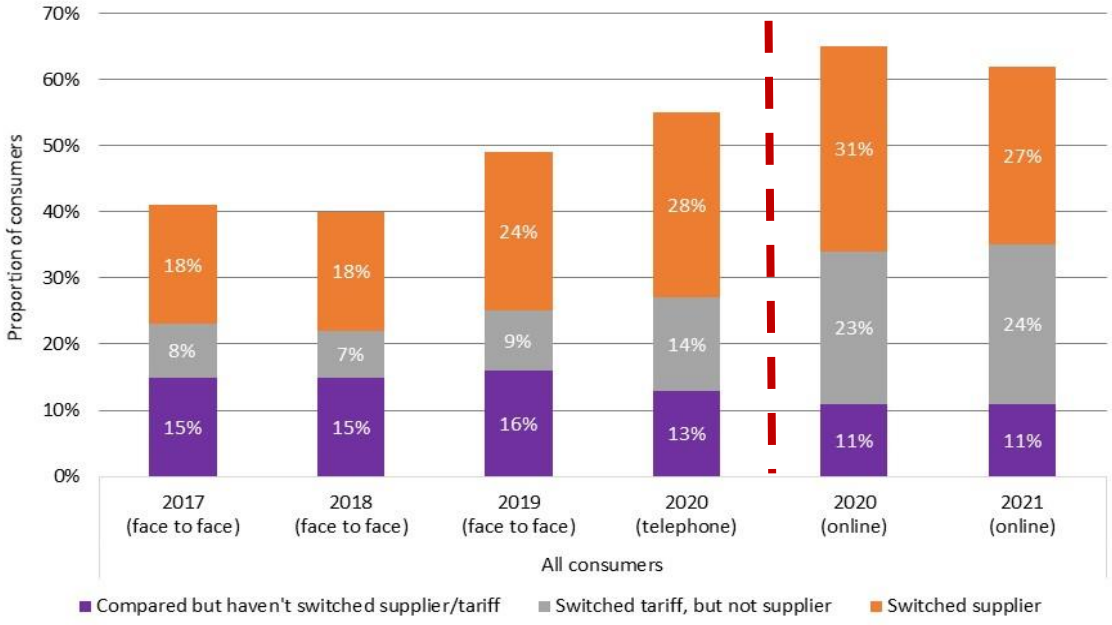
Figure 7: Rolling average annual switching rate



Source: Ofgem analysis of data from electricity distribution network operators (DNOs) and Xoserve –- Retail Monitoring team

3.9. Our previous reviews have also used data from our annual Consumer Survey to assess the number of consumers that engage in other ways, both those that switch tariff but not supplier and those that investigate other tariffs without ultimately switching. Figure 8 shows how this had evolved through to the beginning of the wholesale price volatility.

Figure 8: Proportion of consumers that have switched or compared



Source: Ofgem, Consumer Survey 2017-2021 (fieldwork conducted in August-September 2017-2021)
Notes: The 2020 and 2021 figures are not directly comparable with previous years because the main survey method changed from face-to-face to an online survey. Consumers who answer online surveys tend to be more

engaged with the market and inclined to switch energy deals. They also show greater confidence in their ability to select an energy deal. In 2020, an additional parallel run of the 2020 survey was conducted over the telephone with a smaller sample. The results from the online and telephone surveys are both shown for 2020, as the telephone results are more comparable to the previous face-to-face-surveys, while the online results are more comparable to 2021's online-only survey.

3.10. While we do not have directly comparable figures for the subsequent period, other survey data suggests that while supplier switching fell, in the 8 months after August 2021 25% of consumers searched for a new tariff without then switching. This would be consistent with significant numbers of people wanting to switch but being unable to due to the lack of deals on offer in the market.

3.11. In looking at this engagement data, we should also note the ways in which consumer behaviour may have been influenced by the level of national attention given to events in the market in the second half of 2021. On the one hand, this may have encouraged people to look at the options available to them, given concerns about the rise in prices and the viability of some suppliers. On the other hand, however, there was widespread reporting of the fact that there were no cheaper deals available below the price cap, which may have discouraged some people from even looking.

3.12. Data from Electralink provides supporting evidence that this increased attention significantly influenced certain types of engagement when it was clear that taking action would help to mitigate bill increases: following publicity around the importance of submitting a meter read before the April 2022 price cap increase, 5.7m domestic meter reads were submitted on 31 March - 1 April 2022, a 100% increase on the previous year.

3.13. Overall, we conclude that despite the fall in supplier switching, there are some positive signs around other forms of consumer engagement over the last 12 months. However, we do not yet have sufficient data to draw definitive conclusions, and therefore cannot have confidence that removing the cap would not lead to unfair pricing for disengaged consumers (sometimes referred to as the 'loyalty penalty').

3.14. It should also be noted that without the cap, variable tariff offerings would more likely reflect the volatility of wholesale market prices. The unpredictability of these charges could make it difficult for consumers to meaningfully engage with the market in terms of finding the best deal.

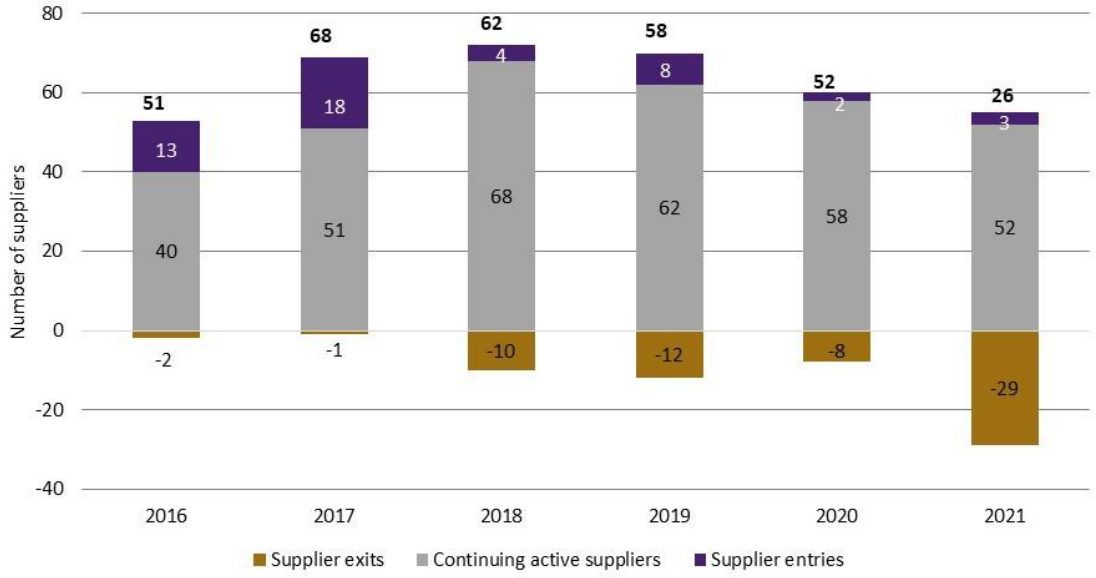
Market structure and dynamics

3.15. The wholesale price shocks have had a noticeable impact on the structure of the energy market, with a higher number of supplier exits, an increase in the market share of large suppliers and an increase in market concentration. We have introduced a number of regulatory changes to improve the market's resilience against this volatility, which are discussed in paragraphs 1.10 and 1.11.

The number of suppliers in the market has fallen sharply

3.16. In 2021, the number of active suppliers in the domestic retail market halved from 52 to 26, with 29 exits occurring in H2 2021. The increase in wholesale prices above the default tariff cap placed intense pressure on suppliers that had not hedged adequately against this scenario. Combined with the unsustainable business models of some suppliers, this led to a wave of failures. In addition to these exits which were managed under the SoLR process, one large supplier, Bulb, entered a Special Administration Regime, while a further three suppliers have exited in Q1 2022.

Figure 9: Annual number of suppliers, entries and exits

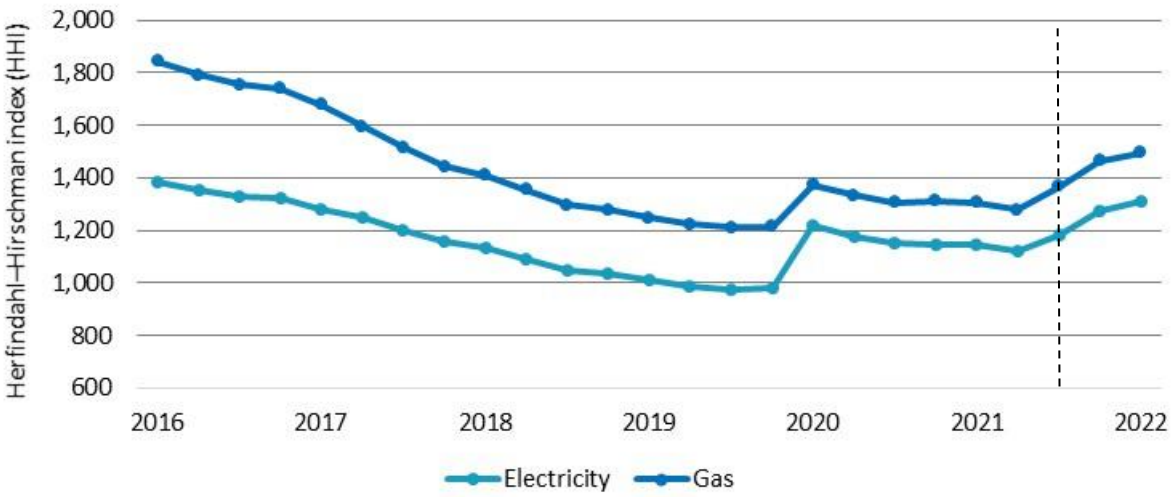


Source: Ofgem's analysis of Distribution Network Operators and Xoserve data.
Notes: "Continuing active suppliers" refers to the number of suppliers at the beginning of each year. The figures above each bar refer to the number of suppliers at the end of each year, having accounted for supplier entries and exits.

Market concentration has risen as the market shares for large suppliers have increased

3.17. Higher levels of market concentration can result in larger suppliers having more market power when setting prices and in the quality of service they provide. The supplier exits in 2021 have led to a noticeable uptick in concentration (see Figure 10), though overall this has not changed our assessment of it as a "concentrated market" under the CMA's market investigation guidance.

Figure 10: Market concentration - Herfindahl-Hirschman Index (HHI)[13]



Source: Ofgem analysis of Distribution Network Operators data
Notes: According to the 2016 CMA Market Investigation guidance, HHI below 1,000 = unconcentrated, HHI between 1,000 and 2,000 = concentrated, HHI above 2,000 = highly concentrated.
Market concentration between 2019 Q4 and 2020 Q1 increased due to the acquisitions of SSE by OVO and npower by E.ON, it then fell over the subsequent two quarters and stabilised up until 2021 Q3.

3.18. The rise in market concentration reflects the increase in market shares of 'large legacy' and 'other large' suppliers (see Figure 11), following on from the wave of small and medium supplier exits in H2 2021. Since mid-2021, the HHI has increased by approximately 14% for both electricity and gas.

3.19. We note that market concentration may also rise further. If Bulb customers are transferred to an existing large supplier, this will further increase the HHI. In addition, a growing number of consumers state they would only consider switching

to a large or well-known energy supplier, although we will not see whether this is borne out in practice until prices fall below the cap.[15].

Figure 11: Electricity market shares by supplier size (and number of suppliers)

Source: Ofgem's analysis of Distribution Network Operators and Xoserve data.

Notes: The threshold for "large legacy" is a market share of at least 5% in either fuel since sector privatisation. The threshold for 'other large' is a market share of at least 5% in either fuel, having increased from below 5% at the time of privatisation. "Medium" suppliers have market share of at least 1% but less than 5% in both fuels, while small suppliers have market share less than 1% in both fuels.

3.20. As illustrated in Figure 11, the electricity market shares of large legacy suppliers has increased marginally, by 2%, while the share of "other large" suppliers has risen by much more, from 12% in Q4 2020 to 21% in Q4 2021. A large factor in this was the rapid growth of Octopus Energy, achieved through a combination of active switches by customers and acquisitions via SoLR processes. However, it also reflects the fact that this category now includes Shell Energy, after its SoLR-related acquisitions took it over the qualifying 5% benchmark. Since Q4 2020, there has been a fall of 6% in the market share of 'medium' suppliers (largely accounted for by the reclassification of Shell Energy) and a fall of 4% in the market shares of 'small' suppliers (reflecting the higher number of small supplier exits).[16]

[15] Ofgem Consumer Impact of Market Conditions survey (2022)

[16] The gas market shares mirror the electricity market shares with usually a difference of no more than 2%.

Supplier performance

3.21. In a well-functioning competitive retail market, we would expect that over time competitive pressures would promote efficiency[17] and limit the scope for excess profits. While the primary aim of the default tariff cap is to protect consumers on default tariffs from being overcharged,[18] it also provides an incentive for suppliers to improve their efficiency through the allowance we set for operating costs.

3.22. In our previous review, we noted that average operating costs had started to reduce, though there was a wide divergence between different companies. Average profit margins had been negative in both 2019 and 2020. The available data for 2021 indicates there has been a 11.4% fall in the aggregate indirect operating costs[19] for large suppliers, while aggregate EBIT[20] margins improved marginally from -1.0% to -0.8%. However, the number of companies reporting this data has reduced to four, as E.ON is no longer required to do so,[21] making it harder to draw conclusions from this. In addition, the events of last autumn may have impacted these figures in a number of different ways. It will take more time to understand what these impacts are on supplier efficiency and profits, and we will continue to monitor this.

Overall conclusion: Condition 2 is not yet met.

3.23. The market disruption since August 2021 created significant uncertainty around the direction of consumer engagement and we do not yet have reliable evidence on whether this has affected existing long-term trends. Similarly, while the wave of supplier exits has led to an increase in market concentration, it is not yet clear whether this has had a meaningful impact on competition.

[17] This metric does not control for all factors that may be relevant to efficiency: for example, it does not control for differences in cost-to-serve. All else constant, a supplier with lower cost-to-serve customers (eg, a higher proportion of customers who pay by direct debit or use online services) will appear more efficient by this metric.
[18] See Ofgem (2018, p.11) "Decision - Default tariff cap - Overview document".
[19] Indirect costs is defined as licensees' own internal operating costs including sales and marketing costs, bad debt, costs to serve, IT, staffing costs, billing and all meter costs, including smart meter costs (eg linked to rollout or asset rental, not DCC).
[20] Earnings before interest and taxes
[21] The definition of a Relevant Licensee is a party that supplies at least 250,000 customers and it (or its Affiliates) holds a generation licence

4. Assessing condition 3: Fair outcomes for consumers

Chapter summary

In this chapter, we set out our view that **Condition 3 is not yet met**. We find that:

- price competition has largely disappeared from the market, with almost all SVTs converging around the default tariff cap, as the cheapest price in the market.
- customer satisfaction is falling, with record low levels of satisfaction in large and medium suppliers and record low consumer satisfaction in comparing suppliers and in the switching process overall.
- trust in energy suppliers is low compared to other industries.

4.1. The competitive process will generate a range of different outcomes for consumers, in terms of the price that they pay for the energy and the service that they receive. As we set out in our decision framework, the competitive process should deliver fair outcomes for consumers, including that: consumers should not be overcharged for their energy use, consumers should receive a good quality of service, and consumers should have access to a range of tariffs to meet their needs.

Prices and price differentials

4.2. The price that a consumer pays for their energy will normally depend in part on the extent to which they have engaged with the market and compared the products and services that are available. Differences in price across products may result from a range of factors, including differences in the range of services that a supplier provides; differences in pricing strategy or differences in underlying efficiency. Price differentials are a feature of competitive markets as suppliers bid to win and retain consumers across the range of products that they offer. A market where many consumers are overcharged is not consistent with effective competition. It means that suppliers do not face enough competitive pressure to constrain their price setting, and to be more cost efficient in order to win and retain consumers.

There has been a high degree of convergence between SVTs across the market

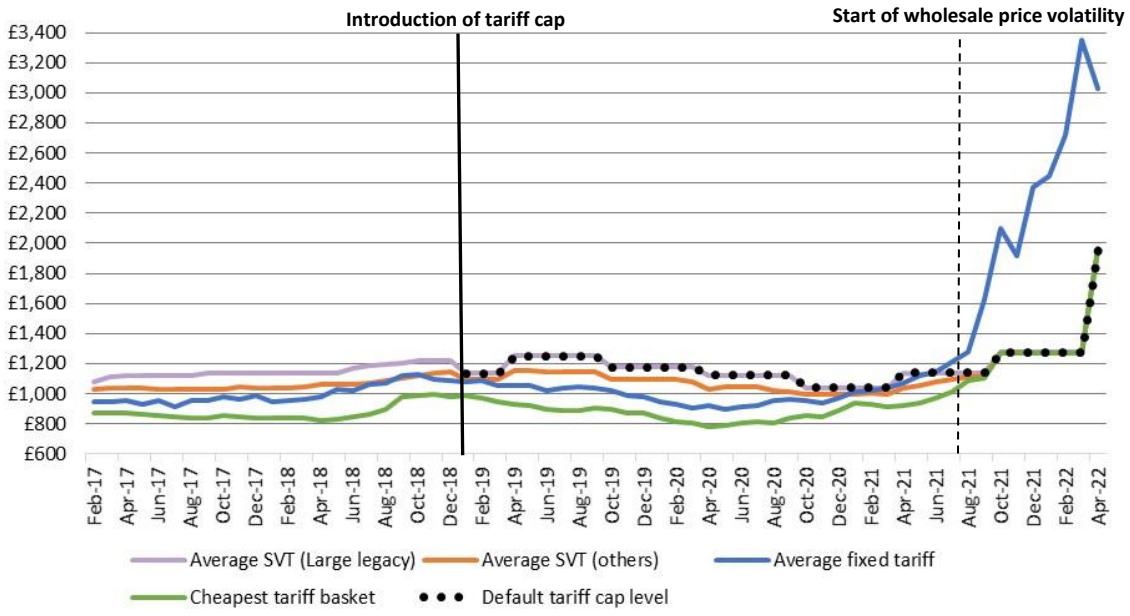
4.3. Figure 12 illustrates the evolution of average SVTs and fixed tariff prices for large legacy and all other suppliers, across 2016-22, along with the average price across

the cheapest basket of tariffs available on the market. The aim of the default tariff cap level is to represent a fair price for energy based on the estimated costs of supplying energy. Prior to August 2021, large legacy suppliers consistently set their SVTs at the default tariff cap level whereas the average SVT from other suppliers was noticeably lower than this. This suggests the legacy suppliers felt little pressure (in the form of customer attrition) to lower the prices of their SVTs.

4.4. Since August, the wholesale prices of electricity and gas have risen substantially above the default tariff cap, and consequently almost all SVTs across the market have been set at the cap level. In January 2021, the price differential between average SVTs for large legacy suppliers and other suppliers was £43, whereas in January 2022 it was £3.

4.5. As the default tariff cap does not apply to fixed tariffs, rising wholesale prices were passed through more quickly to these, with their average level rising above the cap in June 2021, and increasing further since then. Consequently, fixed tariffs have gone from being consistently cheaper than SVTs to being much more expensive.

Figure 12: Average prices of SVTs at typical consumption, 2016-2022



Source: Ofgem analysis of Energylinx (Until May 2017) & Energyhelpline (June 2017 onwards). Data correct as of May 2022

4.6. The recent changes to the price cap methodology announced by Ofgem (as described in paragraph 1.10) will make the price cap more reflective of current market prices. As these changes take effect, and the price cap increases towards the

level of wholesale prices, we expect some degree of price competition to then re-emerge.

Quality of service

4.7. Competitive markets should also drive overall standards of service. As set out in our fairness principles,[22] we expect that where competition is effective, consumers will receive a good quality of service across the different interactions they have with suppliers.

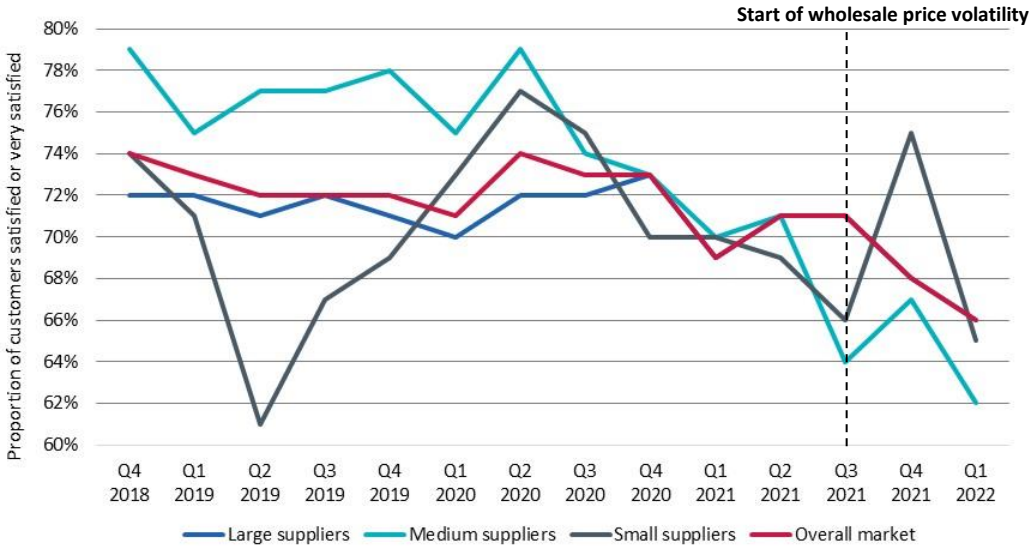
Customer satisfaction is falling

4.8. In Q1 2022, customer satisfaction with the overall market fell to its lowest level since Ofgem launched its current survey in 2018, with satisfaction falling across all types of supplier. Ofgem's findings on this are mirrored by research from Citizens Advice[23], which found that service levels are at their worst since 2017, with increased call waiting times a major driver of this.

4.9. The decline in satisfaction began in Q2 2020, so it is likely that the Covid-19 pandemic was an influencing factor in the early stages of this, but there has been a further marked fall since the market disruption in H2 2021. Not surprisingly, satisfaction with the ease of comparing suppliers, and the overall switching process, have both fallen significantly in the past few quarters.

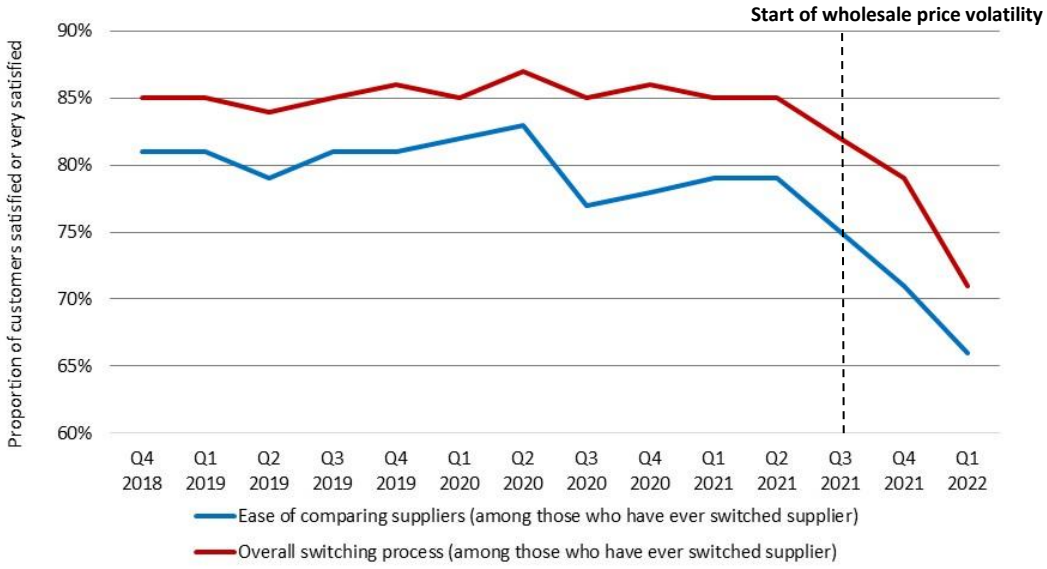
[22] Ofgem (2019) "Decision – Framework for assessing whether conditions are in place for effective competition in domestic supply contracts".
[23] Citizens Advice: 'Worst customer service on record from energy companies, says Citizens Advice'

Figure 13: Overall satisfaction with customer service



Source: Energy satisfaction survey commissioned in 2018 by Ofgem in conjunction with Citizens Advice.
Notes: Up to Q4 2019, 'large suppliers' refer to the historic 'big six'. From Q1 2020, 'large' includes OVO. From Q3 2020, 'large' also includes Octopus and Bulb. Some of the variation in the figure may therefore reflect this changing composition of categories over time. These results are from the survey question "Overall, how dissatisfied or satisfied are you with the customer service you have received from [supplier name]."

Figure 14: Customer satisfaction towards ease of comparing suppliers and overall switching process



Source: Energy satisfaction survey commissioned in 2018 by Ofgem in conjunction with Citizens Advice

4.10. The successive challenges of the pandemic, followed by the price shock, have undoubtedly created difficulties for suppliers in serving their customers. For instance, dissatisfaction with the ease of comparing suppliers may be more of a reflection of rising prices and the lack of price competition resulting from the current

circumstances. Nonetheless it is concerning that call waiting times have worsened at a point where any impacts of Covid-19 should have reduced, and the challenges created for consumers by rising energy prices mean that it is more important than ever for suppliers to provide good service.

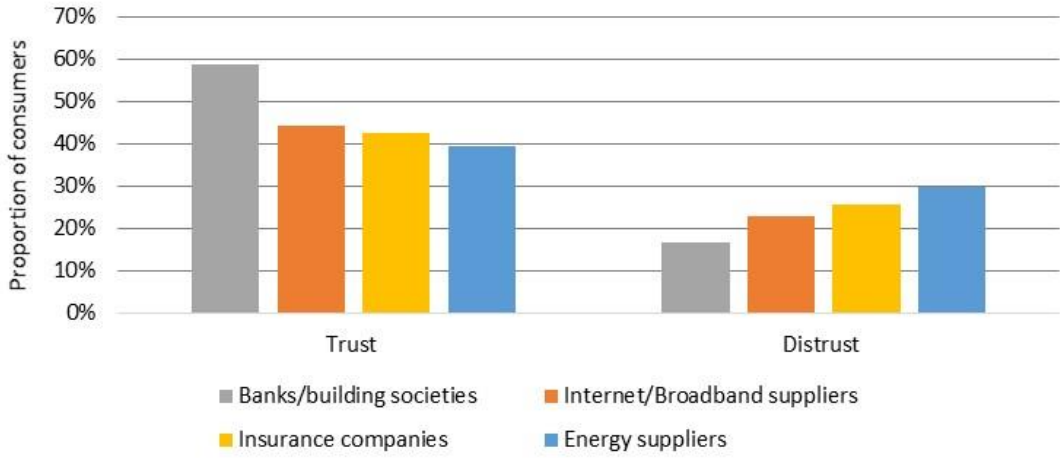
Complaint numbers have remained steady

4.11. The rate of complaints a supplier receives is another indicator of the quality of its customer service levels. Despite the drop in customer satisfaction, there has been no significant change relating to complaints across all categories of suppliers since the last review. However, as reported in paragraph 4.10, call waiting times are increasing and it is becoming more difficult to contact suppliers, which will affect the ability of consumers to make complaints.

Trust in energy suppliers is low compared to other sectors

4.12. When asked which industries they trust to treat them fairly, consumers scored energy suppliers lower than other industries. Notably, other survey sources indicate the figure for energy is slightly higher than it was in August 2021, meaning that recent market events had not negatively impacted this score as of March 2022. There is evidently more that needs to be done to improve perceptions of fairness in the way that energy suppliers deal with consumers.

Figure 15: Consumer trust across different sectors (March 2022)



Source: Ofgem, Consumer Impacts of Market Conditions (fieldwork conducted in March 2022)
Notes: These results are from the survey question "To what extent do you personally trust or distrust each of the following different organisations to be fair in the way they deal with customers and citizens?". 'Trust' is the sum of the proportion of consumers who 'completely trust' and 'tend to trust'. 'Distrust' is the sum of the proportion of consumers who 'completely distrust' and 'tend to distrust'.

The range of tariffs on offer

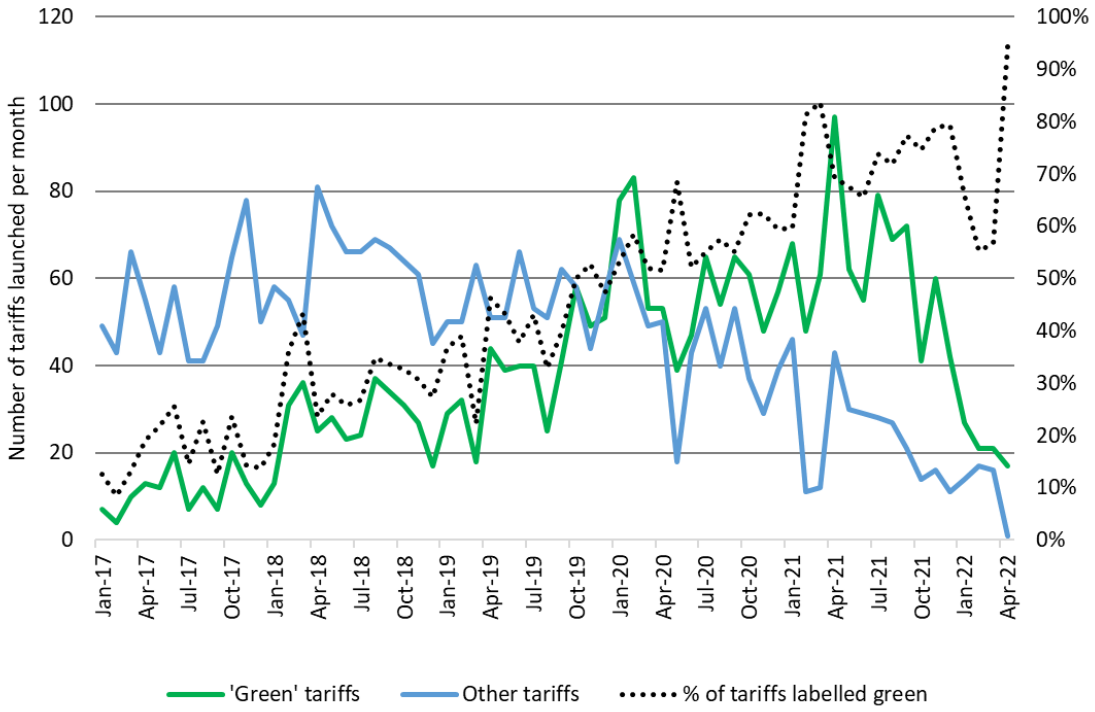
4.13. Consumers differ in their preferences and energy needs: an energy market that is working well for consumers will provide a range of different products to reflect these differences.

4.14. Over the past year, there has been a sharp reduction in the number of tariffs available. At the start of April 2021, there were 212 tariffs on sale, but by the start of April 2022 this had reduced to 80. This fall was caused both by the exits of multiple suppliers and by the rise in wholesale prices causing the remaining suppliers to offer far fewer fixed price tariffs than in the past. Consumers are therefore seeing less choice in the number of tariffs available as well as in the prices on offer.

4.15. As shown in Figure 16 the proportion of new tariffs marked as green has risen steadily since 2017, though we have previously noted our concerns around whether the environmental benefits of these tariffs are being overstated. A government review launched in August 2021[24] is exploring the extent of the latter problem in the retail energy sector and whether the current system is suitably transparent. While the most recent figures show green tariffs making up the entirety of all new offerings, this principally reflects the fact that new tariff launches have slowed to a trickle in the wake of the continuing price volatility.

[24] BEIS - Designing a framework for transparency of carbon content in energy products

Figure 16: Green share of new tariffs launched each month



Source: Ofgem, Energy Helpline. Figures only include tariffs on offer to all consumers.

Overall conclusion: Condition 3 is not yet met

4.16. Price competition has all but disappeared from the market. While we expect this to change at the point that wholesale prices are no longer higher than the price cap, at this point we cannot draw any meaningful conclusions as to how this will evolve in future. In terms of other consumer outcomes, service levels have worsened since last year, and will need to improve substantially for this condition to be met.

5. Conclusions and next steps

5.1. Since our review has concluded that none of the three individual conditions for effective competition are currently being met, we are recommending that the price cap should remain in place to the end of 2023. We are publishing this report alongside a set of decisions relating to the calculation methodology for the price cap that will help to improve the resilience of the market, and protect consumers from the risk of even greater disruption and costs.

5.2. In May 2022, we published the findings of a review we had commissioned from Oxera into the root causes of the recent supplier failures and specifically into how regulation of the industry played a part. One of the key recommendations from this review was to develop frameworks for defining and measuring both effective competition and consumer interest, and to use these to make decisions on future market design options. The NAO has also recently published its report on the recent developments in the energy supply market. Amongst other things, it has recommended that Ofgem should undertake a review of the costs and benefits of the price cap, and should establish a process for considering how new interventions in the retail market would react in a variety of scenarios.

5.3. On the back of these reviews, we will be taking forward a number of initiatives to address their recommendations, including work on a new framework for measuring competition in the domestic market. In addition, we will consider how we may need to update or reform the price cap in future to maintain an appropriate level of price protection as the retail market changes, for example with the introduction of MHHS in 2025 and the growing need for innovative tariff structures that encourage consumer flexibility and promote net zero. These initiatives will be detailed further in our forward work plan.

Appendices

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Appendix 1: Section 7 of the Tariff Cap Act

Section 7 of the Domestic Gas and Electricity (Tariff Cap) Act 2018 sets out the key requirements and timelines for producing this review:[25]

(1) The Authority must carry out a review into whether conditions are in place for effective competition for domestic supply contracts.

(2) Such a review must, among other things, consider the extent to which progress has been made in installing smart meters for use by domestic customers.

(3) Such a review must be carried out –
(a) in the year 2020,
(b) if the tariff cap conditions are extended to have effect for the year 2021, in that year, and
(c) if the tariff cap conditions are further extended to have effect for the year 2022, in that year.

(4) As soon as practicable after carrying out the review, and in any event on or before 31 August in the year in question, the Authority must – (a) Produce a report on the outcome, which must include a recommendation as to whether or not the authority considers that the tariff cap conditions should be extended to have effect for the following year, and
(b) Publish the report and send a copy to the Secretary of State.

(5) After considering the report, the Secretary of State must publish a statement setting out whether the Secretary of State considers that conditions are in place for effective competition for domestic supply contracts.

(6) The statement must be published on or before 31 October in the year in question.

[25] Domestic Gas and Electricity (Tariff Cap) Act 2018