

State of the market report - Assessment framework

Information

Publication date: 19/12/2013

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Overview:

This document sets out how we will assess the state of competition in the energy markets in Great Britain, and how well competition is serving the interests of households and small firms.

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>

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Executive Summary

At a time when consumers are faced with rising energy prices and many are struggling to pay their bills there are inevitably questions about how effectively the energy market¹ is working. Ofgem has previously made clear that in its view the market is not working as well as it should. To address these concerns it has introduced its Retail Market Review (RMR) reforms aimed at making the market simpler, clearer and fairer for consumers. It is also at the final stage of consultation on its liquidity reforms aimed at making it easier for independent suppliers and generators to access and compete in the market.

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

By bringing together Ofgem's knowledge of energy markets with the OFT's wider experience of market assessment, we are aiming to produce a report that will assess how effective competition is in the market and scrutinise key areas of stakeholder concern. This document sets out the framework that we will use in carrying out this assessment.

Given that the RMR reforms are still being implemented and the liquidity reforms have not yet been confirmed, the approach to assessment will recognise that the market may change. It will examine both the features of the market as it stands and the extent to which Ofgem's reforms can be expected to address any competition issues identified.

Furthermore, the market may change through the rollout of smart metering, which offers consumers the possibility of greater visibility and control over their energy use and enables much faster switching. The rollout also aims to support the provision of innovative services by existing suppliers and new market entrants. These services aim to lead to a more active role for consumers in supporting a more sustainable and secure energy market. Our market assessment will reflect these dynamic effects.

Ofgem's vision of a successful energy market is one where suppliers, including a range of new entrants, compete over time to make better offers to consumers and that empowered and engaged consumers incentivise suppliers to compete with each other to deliver efficient and innovative products and services. In this market, there would be high levels of customer service, significant switching in response to price changes, and different supplier strategies around pricing and customer acquisition. There would be competitive pressure constraining the level of prices and profits and driving suppliers to reduce their costs. Ofgem's view would also recognise that energy is an essential service, and that certain groups of consumers that are not able to engage in the market fully are not unduly disadvantaged.

¹ *In this document we use the terms "market" and "markets" as shorthand for referring to different segments of the energy sector. For the avoidance of doubt these terms are not intended to describe or otherwise suggest the approach that may be taken by Ofgem for the purposes of market definition in competition law investigations.*

To assess how well the market is progressing towards this, our framework looks at features on either the demand side or the supply side that might prevent this market functioning as it should. It will look at outcomes for consumers, including those whom Ofgem has a specific duty to consider.

In considering the features that we should look at we have followed a standard typology, based on Competition Commission (CC) guidelines, for looking at potential sources of harm under a number of broad categories. By gathering evidence against a range of indicators in these areas we will test potential sources of harm to establish if there are any areas of concern with the working of the market that may not be addressed adequately by Ofgem's current reforms. While there are inter-linkages between these different areas, we believe that this is nonetheless a useful structure to help us focus our work. The proposed areas are:

Unilateral effects: Given the nature of former incumbent suppliers with relatively large "sticky" customer bases there are questions about whether suppliers individually are able to exploit their positions. Under this heading we will look, for example, at measures of market concentration and switching rates in different sub-markets (eg by region or by fuel) and at outcomes for consumers in these areas.

Weak competition: This area of work will explore the extent to which the six large suppliers are competing vigorously with each other, or whether the nature of the market could make it easy for them, for example, to follow similar strategies with muted price competition resulting. We will look at whether market conditions may lead to weak competition. We will also examine evidence of weak competition such as patterns of price changes, switching levels, customer segmentation and barriers to switching.

Barriers to entry and expansion: With low levels of penetration by new entrants in the domestic market we will examine barriers to entry, exit and expansion. We will look at levels of entry and growth as well as gathering evidence from smaller suppliers and potential new entrants about any entry barriers they may have faced.

Vertical integration: Common ownership of electricity generation and supply may create barriers to entry in both retail and generation markets. We will look at independent suppliers' ability to access wholesale energy on competitive terms and independent generators' ability to sell into those markets, at the transparency of wholesale prices and the trading models of integrated suppliers. We will also look at the available evidence on the level of profits at different levels of the supply chain.

Weak customer response: Ofgem's RMR identified high levels of customer confusion and a lack of confidence in engaging with the market, exacerbated by poor supplier behaviour and the complexity of tariffs. Consumers struggled to access, assess and act on the offers in the market. We will update the evidence Ofgem considered in the RMR. We will also seek views from stakeholders on the expected impact of RMR measures.

In carrying out our assessment, we will look at both the domestic market and the small business market, while recognising that in general past analysis has suggested greater competition and fewer consumer problems in the small business market. The focus of our work will be on the retail market but we will also look at the wholesale market as this affects retail outcomes.

Ofgem has the principal objective of protecting the interests of existing and future energy consumers and is subject to a range of general statutory duties, including duties to have particular regard to sustainability, security of supply and the interests

of vulnerable consumers. While our assessment is focussed on competition, we will also consider whether competition in the market is serving all consumers well, including vulnerable consumers. We will publish our assessment by the end of March. Following this the parties involved – Ofgem, OFT and CMA – will separately consider next steps. These include taking no further action, identifying issues on which to focus assessments in future years, proposing specific reforms or proposing a market investigation reference.

1. Introduction and background

1.1. In its recent response to the Energy and Climate Change Committee, Ofgem committed to report annually on competition in the retail energy markets and on its retail market reforms. This reporting is an important part of ongoing market monitoring work that Ofgem undertakes as part of its duty to protect the interests of consumers.

1.2. The Government subsequently announced that Ofgem would work with the OFT to carry out an annual review into the state of competition in the energy markets and, as far as possible, draw on the expertise of the CMA. This assessment will consider how well competition in the markets for gas and electricity is serving the interests of households and small firms in Great Britain (GB). We will deliver our State of the Market Assessment by the end of March 2014, as we set out in the joint letter from Ofgem, CMA and OFT to the Secretary of State on 5 November 2013².

1.3. Ofgem's principal objective is to protect the interests of existing and future energy consumers. These interests include the reduction of greenhouse gases, the security of the supply of gas and electricity to consumers, and Ofgem's fulfilment of the objectives in the European Union (EU) Gas and Electricity Directives³.

1.4. The OFT's mission is to make markets work well for consumers. OFT considers that markets work well when businesses are in open, fair and vigorous competition with each other for the consumer's custom.

1.5. The CMA's objective is to promote competition, within and outside the United Kingdom (UK), for the benefit of consumers. It will bring together the CC with certain competition and consumer functions of the OFT in order to promote competition, both within and outside the UK, for the benefit of consumers. The CMA was launched in shadow form on 1 October 2013 and will go live in April 2014. Although the CMA is not yet formally established, it will monitor developments and is providing expertise in anticipation of its future role.

1.6. By working jointly on this project we will draw on Ofgem's knowledge and expertise in energy markets and the OFT's wide-ranging experience of assessing competition in a range of markets.

1.7. As a first stage in this process, this document describes the framework we will use to assess the market.

Our annual assessment

1.8. The assessment will be the first annual report on the state of the market. As indicated in our joint letter to the Secretary of State, it will examine how well the markets for gas and electricity are serving the interests of households and small firms.

² <https://www.ofgem.gov.uk/ofgem-publications/84642/ofgemoftandcमतosecretaryofstatecompetitioninenergymarkets.pdf>

³ As set out in the Gas Act 1986 and the Electricity Act 1989.

1.9. Given the timeframes for delivery of the assessment and the ongoing implementation of the reforms under Ofgem’s RMR, this assessment will be published too soon to evaluate the RMR. Ofgem will therefore use a different publication to set out how it will do so and will publish in summer 2014. Our assessment will, however, look at the extent to which Ofgem’s reforms can be expected to address any competition issues identified. Annual reports from 2015 onwards will include both assessment against the scope set out in this framework and the evaluation of the impact of RMR measures.

1.10. As this framework will be used to produce the first annual report, in Chapter 2 we have set out an overview of the sector, briefly explaining the history of the market and the recent developments that have affected it. This includes ongoing and planned developments, such as Ofgem’s RMR reforms and liquidity proposals (see paragraphs 2.53 and 2.54).

1.11. We then articulate, in Chapter 3, our view of what a well-functioning market looks like. This does not attempt to identify specific target metrics or criteria that would signal success, because assessing the degree of competition in the market is not an exact science; no single indicator can in isolation be a good indicator of success. We look across the market at a range of measures and identify the outcomes that we would expect to see if it is functioning well. Based on this, we then set out the structure of our framework against which we will assess the market.

1.12. Finally, in Chapter 4, we set out our view of the features of the market and the potential sources of harm that we will base our analysis around. These are consistent with the approach to market investigations carried out by the CC⁴.

1.13. Our aim is to consider features in the market we can identify that could indicate it is not functioning well. This will also enable us to identify features of the market for potential inclusion in future annual assessments. The range of metrics will expand to include assessment of the impact of RMR and over time could also change to reflect new regulatory interventions or market developments.

Scope

1.14. The aim of this assessment is to determine how well competition in the markets for gas and electricity is serving the interests of households and small firms in GB. Since these groups of consumers interact with suppliers through the retail market, it follows that competition issues in this market have a direct impact on them.

1.15. However, there may be features of the wholesale market, or in the interaction between wholesale and retail markets, that also affect consumers. As a result, we will look at the wholesale market, along with issues such as vertical integration of suppliers, as these have an impact on competition and consumer outcomes.

⁴ We are using the framework described by the CC, but our competition assessment is not a market investigation. (*CC3 Revised*) *Guidelines for market investigations: Their role, procedures, assessment and remedies*, Competition Commission, April 2013, para 10: http://www.competition-commission.org.uk/assets/competitioncommission/docs/2013/publications/cc3_revised.pdf

1.16. Our work will focus on the domestic and small business sectors of the energy market. Past work undertaken by Ofgem, such as the RMR, has suggested that there may be fewer competition problems in the small business sector than the domestic. For this reason our analysis will focus more heavily on domestic consumers.

Consultation

1.17. To help us to develop the framework, we held a stakeholder event on 2 December 2013. We used this event to express our emerging views and held discussion groups focused on our approach and on potential sources of harm. We have used the feedback from this workshop to refine our framework.

1.18. We welcome views from stakeholders on the contents of this framework. We plan to meet with interested stakeholders during January and February, as we undertake and complete our analysis.

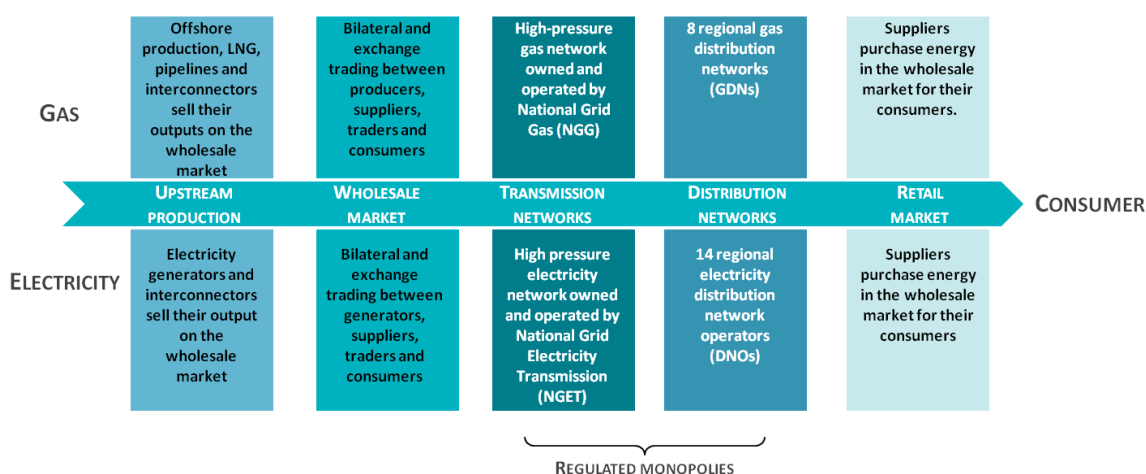
2. Sector overview

Chapter Summary

This chapter provides an outline of how the energy supply chain works, from production to end consumer. It outlines Ofgem’s role in regulating the market and key policy developments in the retail and wholesale markets.

2.1. The energy supply chain in GB consists of a number of different stages, as set out in Figure 1.

Figure 1: additional indicators of a well-functioning energy market in the longer term



Structure of the energy markets

2.2. The retail market comprises gas and electricity suppliers who buy energy from the wholesale market (or directly from producers) and arrange for it to be delivered to the end consumer. They set the prices that consumers pay for the energy they use. They bill consumers and manage all aspects of customer service.

2.3. Electricity is produced by generators who can use a range of energy sources from renewables such as wind power, through to fossil fuels and nuclear which all have different characteristics. Electricity can also be imported or exported through interconnectors.

2.4. Gas comes from offshore production facilities and can be delivered through international pipelines or liquefied natural gas (LNG) terminals and can be delivered into or from storage sites which are used to help manage winter peaks.

2.5. Supply and demand for electricity must be matched, or balanced, at all times. National Grid Electricity Transmission as System Operator has overall responsibility for ensuring that electricity supply and demand match on a second-by-second basis. They have a range of balancing actions open to them including bringing on additional generation or, in extremis, curtailing demand. If a supplier consumes more or less electricity than they have contracted for they are exposed to the ‘cash out’ price for

the difference. Similar rules apply to generators. The 'cash out' price is calculated on a half-hourly basis and the detailed rules are set out in the Balancing and Settlement Code (BSC). These rules are designed to provide incentives on suppliers and generators to minimise their imbalances. Similar arrangements apply in gas where National Grid Gas plc is the System Operator. It has responsibility for ensuring that gas supply matches gas demand on a daily basis.

2.6. For both gas and electricity, trading can take place bilaterally or on exchanges, and forward contracts can be struck over timescales ranging from several years ahead to on-the-day trading. Suppliers can have a range of 'hedging' strategies and will buy energy on different terms in order to attempt to minimise their costs and avoid unnecessary price volatility. Vertically-integrated companies, which own electricity generation or upstream gas assets as well as supply businesses, can also source energy internally to meet their customers' energy demand.

2.7. In order to supply gas or electricity a company must generally have a supply licence. Ofgem can amend licence conditions and take enforcement action in the event of any breaches. Suppliers must comply with consumer protection obligations, for example in relation to disconnection or marketing and sales. Ofgem does not set consumer prices.

2.8. Generators and gas shippers are also regulated by Ofgem but offshore gas production is not.

2.9. Alongside the companies in the generation and supply markets, there are businesses responsible for transporting the gas and electricity from where it is produced or imported to where it is needed. These transmission and distribution network businesses are natural monopolies, and are regulated through price controls where Ofgem sets the revenue that they can recover from users. These arrangements also seek to incentivise the companies to improve efficiency (keeping costs down for consumers), innovate technically and to act in line with the interests of consumers and other stakeholders.

Retail market developments

Market structure developments

2.10. Before competition was fully introduced into the retail energy markets (which was completed by 1999), British Gas and the fourteen regional Public Electricity Suppliers (PESs) had a monopoly to supply all domestic gas and electricity consumers respectively in GB. In the subsequent five years the number of suppliers in the market fell to six as a result of horizontal mergers. Some of these businesses also merged with generation companies to create vertically-integrated groups.

2.11. The six largest suppliers in GB now serve around 97% of the domestic retail gas and electricity market⁵, and own around 70% of the generating capacity⁶. In the gas sector, vertical integration is less of a feature. Only Centrica (British Gas) has significant gas production capability as a part of its UK group, with production in

⁵ Ofgem analysis based on data provided by electricity DNOs and Xoserve

⁶ Ofgem analysis based on DECC, Digest of United Kingdom Energy Statistics, 2013

2012 representing around a third of its GB supply requirements for domestic and Small to Medium Enterprise (SME) consumers⁷.

2.12. There are around a dozen diverse smaller suppliers serving almost 3% of the market, three of whom have more than 100,000 customer accounts. The market share of small and independent electricity suppliers has nearly trebled from January 2011 to August 2013⁸.

2.13. There are a larger number of suppliers in the non-domestic market than in the domestic market, with a total of 32 suppliers, against 13 suppliers to domestic consumers⁹. The six largest suppliers supply 92% of non-domestic non-half hourly electricity sites (85% by volume) and 68% of non-domestic non-daily metered gas sites (33% by volume), which typically belong to smaller businesses¹⁰.

2.14. At a regional level, the predominance of the incumbent gas and electricity suppliers remains. For single fuel accounts, an average of more than 70% of consumers are supplied by either British Gas or the regional electricity incumbent¹¹.

Consumption

2.15. Almost all domestic households are connected to mains electricity supply, but only 85% of these also have mains gas supply¹². Domestic consumption for gas and electricity has fallen since the middle of the last decade. Data published by DECC shows that, from 2008 to 2012, aggregate annual domestic consumption fell by 9% for gas and 6% for electricity¹³.

2.16. Non-domestic energy demand includes demand from small business consumers, as well as larger industrial and commercial consumers. Data published by DECC shows that from 2008 to 2012 aggregate non-domestic electricity consumption fell by around 9%, and aggregate non-domestic gas consumption fell around by 11%¹⁴.

Prices

2.17. The Retail Prices Index (RPI) of gas and electricity prices have generally risen since 2003, with steeper price rises since 2005. There were nominal price falls in 2009 and 2010, but these were smaller than subsequent price rises.

⁷ Ofgem analysis based on data provided by Datamonitor

⁸ Ofgem analysis based on data provided by electricity Distribution Network Operators

⁹ As of 2012, The Retail Market Review – Updated proposals for businesses, 2012
<https://www.ofgem.gov.uk/ofgem-publications/39455/retail-market-review-updated-proposals-businesses.pdf>

¹⁰ Based on August 2013 data provided by Datamonitor

¹¹ The Retail Market Review – Updated domestic proposals, <https://www.ofgem.gov.uk/ofgem-publications/39457/retail-market-review-updated-domestic-proposals.pdf>
<https://www.ofgem.gov.uk/ofgem-publications/39455/retail-market-review-updated-proposals-businesses.pdf>

¹² OFT Market Study, 2011 (Table A5) http://www.oft.gov.uk/shared_of/market-studies/off-grid/OFT1380annexes.pdf

¹³ <https://www.gov.uk/government/publications/energy-consumption-in-the-uk>

¹⁴ Excluding energy used in energy production and energy losses. Based on Digest of United Kingdom Energy Statistics 2013 data.

2.18. There are a number of factors that influence domestic gas and electricity prices. These include fluctuating wholesale gas and electricity prices, the cost of Government and EU policies, the cost of investment in the networks needed to transport gas and electricity, and changes in other supplier costs and profit margins.

Wholesale costs

2.19. Wholesale costs are the biggest single component of consumer bills, making up around 46% of domestic consumer bills in November 2013¹⁵. Ofgem has estimated that over the last ten years, wholesale electricity costs have risen by around 140% and gas costs by 240%¹⁶.

2.20. Higher gas prices have been a key driver of increasing energy bills over the last ten years. Gas prices also have an impact on wholesale electricity prices given the importance of gas-fired generation in GB – gas has made up the largest share of electricity generation over the last decade. Recent higher gas prices have meant that more coal is used to generate power in the UK than gas, but since gas is the marginal generation source, changes in its price provide a good guide to changes in the wholesale cost of electricity¹⁷.

2.21. In the last ten years, Britain has become increasingly more reliant on imported gas, which has meant that gas prices have become increasingly influenced by global factors. These factors include changes to oil prices, as European gas prices are often linked to these prices.

Network costs

2.22. Network costs are made up of the costs of building, maintaining and operating the transmission and distribution networks, which transport gas and electricity from source to end consumers. Generators and suppliers are charged for using these networks under a system of price controls regulated by Ofgem.

2.23. During the first 15 years after privatisation, cost efficiencies have meant that charges paid by suppliers for the use of networks reduced by approximately 50%. However, recently there has been a rise in network costs in order to build new networks to help connect low carbon energy, replace old gas mains and renew ageing parts of the network.

2.24. The Government announced in its 2013 Autumn Statement that electricity distribution network companies are willing to take voluntary action to reduce network costs in 2014/15. This would allow a one-off £5 reduction in electricity bills, which suppliers will be able to pass on to their customers¹⁸.

Cost of meeting environmental social policies

¹⁵ <https://www.ofgem.gov.uk/gas/retail-market/monitoring-data-and-statistics/electricity-and-gas-supply-market-indicators>

¹⁶ <https://www.ofgem.gov.uk/publications-and-updates/understanding-energy-prices>

¹⁷ Generators are brought online in price order, lowest first, until enough comes online to fulfil overall demand. Prices therefore tend to reflect the offers of the last plant to be called before overall demand is met (or marginal plant). Recently this has tended to be gas-fired generating plant.

¹⁸ <https://www.gov.uk/government/news/govt-action-to-help-hardworking-people-with-energy-bills>

2.25. There are a number of policies set by Government that aim to meet various environmental and social objectives. These policies include Energy Companies Obligation (ECO)¹⁹, the Warm Home Discount²⁰, the Renewables Obligation, and Feed-in Tariffs. The costs of these policies are borne indirectly by consumers. Recently, the Government announced that it intends to reduce the cost of the ECO. It also intends to provide a rebate to consumers to cover the cost of the Warm Home Discount²¹.

Long-term energy market context

Prices and demand

2.26. In 2009 Ofgem estimated that up to £200 billion of investment would be needed within 10-15 years across the GB electricity and gas supply chain to meet environmental targets and secure energy supplies. This investment requirement implied that elements of consumers' bills would need to increase. A range of government and regulatory policy initiatives aim to deliver this necessary investment in an efficient manner such as DECC's Electricity Market Reform²² and Ofgem's RIIO price controls²³.

2.27. The long-term future of gas supplies will depend on global supply and demand. On the supply side two important factors are: how gas supplies from Russia and Central Asia develop; along with the impact of European shale gas on gas supplies. Future demand from Asia and elsewhere around the world will also have an impact on GB, which must compete on the world market for gas supplies.

2.28. Economic growth and energy efficiency are likely to be key factors driving overall demand, specifically for domestic and smaller non-domestic consumers. National Grid estimates that residential electricity demand will plateau in the short term, then fall due to energy efficiency improvements. Demand may climb in the 2020s because of greater use of electricity in transport and heating, but the rate and timing of this are more uncertain. Domestic demand for gas is estimated to fall towards the end of this decade, with more uncertainty as to whether this trend will continue beyond 2020.

Smart Metering

2.29. The Government has said that all homes and businesses should have smart meters by 2020 and has put licence obligations on suppliers to do this. The main rollout is due to start in 2015 once the centrally procured communications infrastructure is in place. However, some suppliers are rolling out smart meters

¹⁹The Energy Companies Obligation places obligations on the larger energy suppliers to deliver energy efficiency measures to domestic energy users.

²⁰The Warm Home Discount is a scheme which requires domestic energy suppliers to provide support arrangements to fuel poor consumers

²¹ Further detail about the Government's recent announcements can be found at:

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263942/35062_Autumn_Statement_2013.pdf

²² Electricity Market Reform documents: <https://www.gov.uk/government/policies/maintaining-uk-energy-security--2/supporting-pages/electricity-market-reform>

²³ <https://www.ofgem.gov.uk/network-regulation-%E2%80%93-riio-model>

already and more than 980,000 smart or smart-type meters were installed by the end of September 2013²⁴.

2.30. Smart metering will give consumers much greater visibility and control over their energy use (in part through an in-home display to be given to all domestic consumers) and should ultimately allow much faster switching. By recording usage on a half-hourly basis and allowing for direct load control, it may also support the provision of innovative services by existing suppliers and new market entrants. These services, including time of use tariffs, should lead to a more active role for consumers in supporting a more sustainable and secure energy market. Our market assessment will need to reflect these dynamic effects and the changing characteristics of a well-functioning market.

How Ofgem regulates the market

2.31. Ofgem is the regulator of GB's gas and electricity markets. Its powers, duties and objectives come from GB statutes and relevant EU legislation.

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

2.33. When performing regulatory functions, Ofgem is also subject to a wide range of other general duties which include (but are not limited to):

- a duty to act in the manner it considers is best calculated to secure a diverse and viable long-term energy supply;
- duties to have regard to a wide range of matters including:
- better regulation principles;
- the need to secure that all reasonable demands for electricity are met;
- the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- the need to secure that licence holders are able to finance their activities;
- the need to contribute to the achievement of sustainable development; and
- the interests of individuals who are chronically sick, of pensionable age, with low incomes or live in rural areas, as well as to those of other consumers.

²⁴ <https://www.gov.uk/government/publications/smart-meter-statistics-data-quarter-3-2013>

2.34. Ofgem conducts investigations into the conduct of companies that it believes may be breaching licence conditions, the Competition Act or consumer protection laws²⁵. It may also make a market investigation reference to the Competition Commission where it has reasonable grounds for suspecting that any feature or combination of features prevents, restricts or distorts competition in the gas and electricity markets.

Key policy developments in the retail market

2.35. As part of its wider monitoring duties, Ofgem monitors and reviews the retail market. In recent years it has carried out two full-scale market reviews. Each led to new licence obligations being placed on suppliers with the aim of addressing features of the market that were harming the interests of consumers. We describe each below.

Energy Supply Probe

2.36. The Energy Supply Probe (‘the Probe’) was an investigation into the functioning of the gas and electricity retail markets. It resulted in a package of measures with the aim of making competition work more effectively so that the benefits could be realised by consumers²⁶.

2.37. Launched in February 2008, the investigation looked at a range of areas, including consumers’ experience of the market; switching rates and suppliers’ pricing of different market segments; the relationship between retail and wholesale energy prices; suppliers’ market shares; liquidity; and entry into the market. The study focused on domestic and small business consumers.

2.38. The Probe found that the fundamental structures of a competitive market were in place, and the transition to an effective competitive market was well advanced and continuing to develop. It found no evidence of a cartel, and concluded that retail price rises could be justified by changes in wholesale costs. However, the investigation did identify a range of features in the market that weakened competition and meant that the market was not working in the best interests of consumers. These included structural features, reinforced by the behaviour of suppliers, and the lack of engagement and poor decision making by consumers.

2.39. In particular the Probe found continuing high levels of market concentration with no significant “competitive fringe”. While there was a high level of switching among a small group of active consumers, poor selling practices by suppliers resulted in many consumers switching on the basis of poor or partial information with as many as a third of switchers not receiving a price reduction. The high levels of customer switching were found not to be exerting as much of a constraint on suppliers’ pricing as it could. As a result suppliers were able to charge higher prices to certain groups of consumers including those in their former monopoly areas, pre-payment meter consumers and electricity only consumers.

²⁵ <https://www.ofgem.gov.uk/ofgem-publications/64011/factsheet-113-enforcement.pdf>

²⁶ Energy Supply Probe documents: <https://www.ofgem.gov.uk/retail-market-review/background-energy-supply-probe>

2.40. Following consultation, Ofgem developed measures aiming to address these issues and improve the functioning of the market. These included a number of measures with the aim of improving the provision of information, and remedies addressing poor supplier conduct. It introduced this package of measures through new licence conditions that became effective between September 2009 and July 2010.

2.41. The first part of this package aimed to address concerns over unjustified price differentials. Ofgem introduced new licence conditions requiring any difference in the terms and conditions offered by suppliers in respect of different payment methods to be cost reflective and prohibiting undue discrimination in any terms and conditions offered to consumers. The prohibition on undue discrimination was seen as an interim measure until competition became effective. It was therefore time limited and expired on 31 July 2012. In October 2012 Ofgem decided not to reintroduce this prohibition²⁷, in light of the wider RMR.

2.42. The second part of the package aimed to promote competition and consumer engagement. It included obligations on suppliers to improve the information they provide to consumers on bills and in an annual statement; to help vulnerable and indebted consumers who are currently blocked from changing suppliers due to outstanding debts; to improve the conduct of their sales and marketing activities; to help small business consumers by providing them with better information regarding the terms and conditions of their contracts.

2.43. Ofgem also presented suppliers with a challenge to improve their conduct towards consumers, through voluntary standards of conduct and rules on the information they provide to consumers. It intended to take further steps if these standards were not adhered to. These high-level requirements aimed to help consumers to become more engaged in the market.

2.44. The Probe also highlighted features of the wholesale market that were creating barriers to entry into the retail energy market. Consequently, Ofgem launched its work to improve liquidity in the wholesale markets in order to improve prospects for entry (paragraph 2.53). It also introduced requirements for companies to produce segmental statements showing their supply and generation profits separately to aid transparency²⁸.

Retail Market Review²⁹

2.45. Following the Probe, Ofgem's regular monitoring of the retail market raised concerns that some areas of the market were still not working effectively in the interests of consumers. In particular, suppliers were not complying with the standards of conduct. The RMR was therefore launched to establish suppliers' progress in implementing the Probe reforms and whether further actions were necessary to address any remaining issues. The review built on the analysis and findings of the Probe and carried out additional analysis to assess the effectiveness of

²⁷ <https://www.ofgem.gov.uk/ofgem-publications/39471/decision-standard-condition-25a-gas-and-electricity-supply-licences.pdf>

²⁸ 2012 segmental accounts: <https://www.ofgem.gov.uk/publications-and-updates/energy-companies-publish-2012-consolidated-segmental-statements>

²⁹ Retail Market Review documents: <https://www.ofgem.gov.uk/retail-market-review/retail-market-review-publications>

the retail energy markets and whether consumers were experiencing persistent harm.

2.46. The review found that while there had been improvements in certain areas since the Probe, many of the problems with consumer engagement remained and there was evidence of persistent consumer harm.

2.47. Of particular concern were the growing complexity of tariffs, which meant consumers found it hard to make a well informed choice of supplier, and the lack of any obvious decision or trigger point for engagement for consumers on evergreen contracts. The RMR found that a significant proportion of consumers had particular difficulty engaging in the market as a result of their circumstances (eg lack of bank account or internet access). It found that as a result there were a high proportion of “sticky” consumers. The ability of suppliers to segment the market and earn higher margins from these consumers was seen as likely to lead to consumer harm both directly (where it impacted on vulnerable consumers) and by weakening the intensity of competition in the market. This was reflected in continued high regional market shares and rising margins. The RMR also found that supplier behaviour had not improved following the introduction of voluntary standards of conduct with low levels of trust and confidence in the market.

2.48. Ofgem concluded that further action was needed to make the retail markets work more effectively in the interests of consumers. Evidence and consultation established that retail energy markets could be made much more accessible for consumers while also retaining the scope and incentives for suppliers to innovate and compete.

2.49. After further research and consultation, Ofgem introduced additional measures based in part on the experience of how suppliers responded to the less prescriptive, more voluntary arrangements introduced as part of the Probe. The changes focused around three key areas with the aim of improving simplicity, clarity and fairness in order to combat issues with lack of tariff comparability, lack of understanding and lack of trust in the market. The new rules aim to strip away unnecessary complexity in tariff choices, arm consumers with better, more relevant information on the available choices and establish legally binding fairness obligations on suppliers. They also aim to ensure that all business consumers, and particularly small businesses, are clear about their options when fixed term contracts come to an end.

2.50. The overall objective of the remedies was to make it easier for consumers to get a better deal for them and to improve effective consumer engagement so as to increase competitive pressure on suppliers’ pricing and other practices. Within this objective, Ofgem aimed to improve the choices that individual consumers make and widen the pool of consumers who are confident to engage in the market.

Other retail market developments

2.51. There are a number of other strands of work that Ofgem currently has in progress that will impact on the effective working of the retail market. Some of these came out of the RMR work, while others are linked to the rollout of smart metering:

- A project (“Market Cheapest Deal”) which is looking at how best to support engagement of the most vulnerable and “sticky” consumers.

- A programme of work looking at the role of third party intermediaries (including switching sites in the domestic market and brokers in the non-domestic market). Third parties have an important role to play in supporting consumer engagement, but consumers need to have confidence in the independence of the advice that they receive. Ofgem is responsible for the Confidence Code³⁰, which governs switching sites, and has been working with industry to develop a code of practice for non-domestic intermediaries.
- A programme of work looking at how to improve the switching process, recognising that concerns about lengthy or problematic switching can be a barrier to consumers engaging. Currently a high proportion of switches take over five weeks with a valid reason – over 80% in gas and 20% in electricity – and 1% of switches are made in error (ie switching the wrong consumer). Ofgem is consulting on licence changes requiring suppliers, in the short term, to provide a reliable five week switch. In parallel, industry has made a commitment to the Secretary of State to look at changes that could be made to the central systems to significantly speed up the process. Ofgem will consult on more radical long-term changes, linked to the rollout of smart metering, that could deliver next-day changes of supplier for consumers.
- A programme of work looking at how to reform the settlement arrangements to use the half hourly data that will be provided through smart metering. The work aims to ensure that suppliers face appropriate cost signals to encourage consumers to manage their energy usage profile through the day and at times of supply shortage.
- A project looking at the role of white label suppliers and alternative models such as Ofgem’s Licence Lite regime that might offer alternative routes for new entrants looking to enter the market but who do not want to have to deal with the complexities of industry arrangements such as balancing and settlement.
- Work to look at how to improve the transparency of suppliers profit reporting including the split between supply and generation.

Key policy developments in wholesale markets

The Government's Electricity Market Reform (EMR)

2.52. EMR is the Government’s policy for reforming the electricity system to ensure the UK’s future electricity supply is secure, low-carbon and affordable³¹. The key elements of EMR are contracts for difference, which will support new investment in all forms of low-carbon generation (renewables, nuclear and carbon capture and storage), and a capacity mechanism which would provide incentives for investment in the overall level of reliable capacity (supply and demand side) needed to ensure secure electricity supplies. In addition, a carbon price floor will be introduced in April 2014. While most changes that will be introduced will have more direct impacts on

³⁰ <https://www.ofgem.gov.uk/information-consumers/domestic-consumers/switching-your-energy-supplier/confidence-code>

³¹ Information on the Department of Energy and Climate Change’s Energy Market Reforms: <https://www.gov.uk/government/policies/maintaining-uk-energy-security--2/supporting-pages/electricity-market-reform>

the wholesale electricity markets, costs will be recovered through levies on suppliers ('supplier obligations').

Ofgem's liquidity proposals

2.53. Ofgem's liquidity proposals aim to make it easier for small suppliers to enter the market³². These proposals set out three objectives which reflect key characteristics needed in the wholesale market in order to effectively support competition: availability of products that support hedging; robust reference prices; and an effective near-term market.

2.54. As part of these proposals Ofgem is currently undertaking a statutory consultation to introduce a new special licence condition into the generation licences of the eight largest electricity generating companies³³. The licence condition aims to improve access to the wholesale electricity market by requiring these companies to follow a set of 'Supplier Market Access' rules when trading with small independent suppliers. It also aims to ensure that the market provides the products and price signals needed to compete effectively through a market making obligation on the six largest vertically integrated companies³⁴. Subject to responses to a statutory consultation that closes on 18 December, changes will be made to licences in early 2014³⁵.

Price Reporting Agencies

2.55. In June 2013, following concerns about price reporting in the gas market, Ofgem considered the role of reference prices and the factors that determine the ability of price reporting agencies to make price assessments that represent a fair reflection of the market³⁶.

European financial legislation

2.56. There are a number of developments in European financial legislation that apply to GB that may have an impact on how participants trade in the wholesale energy markets. The Regulation on Energy Market Integrity and Transparency (REMIT), introduced prohibitions on market abuse in the wholesale energy market. In addition it places new obligations on market participants to disclose information to the market. Ofgem received new powers to monitor, investigate and enforce breaches of the market abuse prohibitions and reporting obligations on market participants in June 2013.

2.57. The European Market Infrastructure Regulation (EMIR) obliges central clearing for certain classes of over-the-counter derivatives. When taken with other aspects of European energy market integration, there could potentially be a move away from bilateral trades and towards more centralised trading. The Markets in Financial Instrument Directive and Regulation (MiFID and MiFIR respectively) establishes a

³²Information available at: <https://www.ofgem.gov.uk/electricity/wholesale-market/liquidity>

³³ Centrica, Drax, EDF Energy, GDF Suez, E.On, RWE npower, SSE and Scottish Power

³⁴ Centrica, EDF Energy, E.On, RWE npower, SSE and Scottish Power

³⁵ <https://www.ofgem.gov.uk/publications-and-updates/wholesale-power-market-liquidity-statutory-consultation-secure-and-promote-licence-condition>

³⁶ <https://www.ofgem.gov.uk/publications-and-updates/pricing-benchmarks-gas-and-electricity-markets-call-evidence>

harmonised regulatory framework for the provision of investment services in financial instruments. Changes to MiFID and its interpretation may affect the definition of what constitutes a financial instrument. The effect of this may be to increase the scope of financial legislation to cover trading in a wider range of energy markets.

European Integration

2.58. The level of physical interconnection with other European markets has increased over the last decade, and European legislation, known as the third package, aims to create a single European Energy Market. The European Target Model is the main regulatory vehicle for achieving market integration across Europe. It establishes common rules to facilitate efficient use of cross-border capacity and to encourage harmonisation of European wholesale market arrangements.

Gas security of supply and electricity balancing significant code reviews

2.59. The Significant Code Review (SCR) mechanism is designed to facilitate complex and significant changes to the codes that energy companies are required to abide by. It enables Ofgem to undertake a review of a code-based issue and play a leading role in facilitating code changes through a review process.

2.60. The Gas Security of Supply SCR began in January 2011 to investigate improving the incentives on shippers to avoid an emergency, encouraging voluntary demand side response, and ensuring that consumers are paid appropriately if their gas supply is interrupted in an emergency³⁷. Ofgem's Updated Proposed Final Decision was published in July 2013. If confirmed, changes are expected to be implemented ahead of winter 2015/16.

2.61. The Electricity Balancing SCR is investigating changes to the incentives on market participants to balance their positions in the electricity market³⁸. A draft policy decision was published in July 2013 and a final policy decision is scheduled for Spring 2014³⁹.

³⁷ <https://www.ofgem.gov.uk/gas/wholesale-market/market-efficiency-review-and-reform/gas-significant-code-review>

³⁸ <https://www.ofgem.gov.uk/electricity/wholesale-market/market-efficiency-review-and-reform/electricity-balancing-significant-code-review>

³⁹ <https://www.ofgem.gov.uk/publications-and-updates/electricity-balancing-significant-code-review-draft-policy-decision>

3. The assessment framework

Chapter Summary

This chapter outlines the assessment framework that we will use in our first (2014) annual State of the Market Report. This includes a description of a well-functioning market and an explanation of how we will use data to assess the market.

3.1. The purpose of the assessment framework is to set out how we will carry out our analysis in order to assess the state of the market, in terms of both competition and a wider set of outcomes relevant to Ofgem’s principal objective and general duties. It is designed to be an enduring framework that can be used, or adapted in future years, as necessary.

3.2. The framework consists of three stages:

- A description of a well-functioning market, and how competition should work to deliver desired outcomes;
- An explanation of the broad categories of reasons why the competitive process may not be working as it should (potential ‘sources of harm’); and
- An explanation of how we will use data and information (‘indicators’) to identify features of the market and analyse, investigate and conclude on how these features affect the process of competition and outcomes for consumers, including vulnerable consumers.

3.3. Below, we describe a well-functioning market. In Chapter 4 we describe five potential sources of harm and summarise how we will investigate possible issues to assess competition.

Description of a well-functioning energy market

3.4. The framework, like other competition assessments, uses the concept of a hypothetical well-functioning energy market. This well-functioning market acts as a comparator against which we can assess the effects on competition of identified features of the market. It is not an idealised or perfectly competitive market, but one that allows the benefits of competition to occur. In describing this well-functioning market, we recognise that energy is an essential service and that there are certain groups of consumers who are not able to engage in the market as much as others.

3.5. These beneficial effects are shown in the CC’s Guidance on Market Investigations:

Competition is a process of rivalry as firms seek to win customers’ business. It creates incentives for firms to meet the existing and future needs of customers as effectively and efficiently as possible—by cutting prices, increasing output, improving quality or variety, or introducing new and better products, often through innovation; supplying the products customers want rewards firms with a greater share of sales. Beneficial effects may also come from expansion by efficient firms and the entry into the market of new firms

with innovative products, processes and business models, and the exit of less successful ones⁴⁰.

3.6. Because competition is a dynamic process that produces changing outcomes, the characteristics of a well-functioning market will change over time. Below, we look at some of the characteristics we would expect to see in a well-functioning energy market in the short and longer term. These characteristics reflect both the more immediate allocative benefits of competition, and also the more dynamic benefits which occur over time.

3.7. We also show possible indicators that we could use to describe outcomes in such a market. These indicators need to be considered together and in the round. No single indicator alone can be used as a measure of whether the market is functioning well.

3.8. In the short term, we consider that a well-functioning energy market would be characterised by consumers being engaged and empowered to secure good outcomes when they participate in the market. For example, they should receive good service and clear, understandable communications. We would also expect to see pressure on suppliers' costs and margins.

3.9. Below, we set out some of the possible indicators that we might use to assess whether the market was becoming better-functioning in the short-term. These indicators should not be considered individually, but rather as one source of evidence to assess the health of a market.

Figure 2: indicators of a well-functioning energy market in the shorter term

Market outcome	Indicator
High engagement	Switching levels (internal or external), consumer research metrics, switching drivers, switching elasticities
Good service	Customer complaints information, consumer research metrics, number of consumers in debt, number of disconnections, debt repayment rates
Clear communications (eg bills, letters)	Consumer research metrics
Pressure on supplier costs	Cost efficiency, observable pricing strategies
Pressure on margins	Profitability (per customer), margins (including for different market segments and small suppliers' margins), value chain profitability

3.10. In the longer term, we would expect the outcomes described in the section above to persist. In addition, a well-functioning market would be characterised by further changes in suppliers' behaviour, leading to a more dynamic, innovative market. In such a market we would expect to see suppliers and new entrants (some

⁴⁰ (CC3 Revised) Guidelines for market investigations: Their role, procedures, assessment and remedies, Competition Commission, April 2013, para 10: http://www.competition-commission.org.uk/assets/competitioncommission/docs/2013/publications/cc3_revised.pdf

using new commercial models) reacting to changes in the market to offer consumers new products and services.

3.11. This dynamic rivalry could be expected to drive further engagement and participation in the market. Importantly, this market would deliver basic services more efficiently and to a better standard (quicker, more cheaply, more tailored etc), as well as new and innovative services.

3.12. Over a longer timeframe, we would also expect to see this dynamic competition making the most of new opportunities arising from new technological, market or regulatory developments. For example, once smart metering rolls out to domestic consumers, suppliers and others could take advantage of opportunities to offer more innovative products and services (such as time-of-use tariffs and other demand-side response products) that fully leverage the opportunity that smart metering presents. This might be reflected in innovation and wider opportunities for consumers to manage their energy consumption; all provided alongside a continued high standard of service.

3.13. Below are some of the possible indicators that we might use to assess whether the market is becoming better-functioning over a longer timeframe. Again, these indicators should not be considered individually, but rather as one source of evidence to assess the health of a market.

Figure 3: additional indicators of a well-functioning energy market in the longer term

Market outcome	Indicator
Wide choice of retailer, demonstrable ability to grow from new entry	New entrants at each level of the supply chain, size and growth of recent entrants, entry costs, barriers to entry
Tariffs responsive to consumer needs	Innovative tariffs
Sustained, significant, dynamic rivalry	Changing shares in different market segments (regional, payment type, fuel, tariff type eg online), concentration ratios, new and different consumer acquisition strategies / corporate strategies, market entry, market exit / merger activity
New commercial / business models	New entrants or existing suppliers responding to changing market opportunities, new ways of consumers engaging with energy, offerings linked to other services
High quality of service and consumer trust	Complaints information, supply interruptions, consumer research metrics, switching experience (time & reliability vs. industry standards)

4. Potential sources of harm and features of the market

Chapter summary

In this chapter we describe our approach to identifying potential sources of harm to competition and features that may cause this harm. We have identified five potential sources of harm, under which we will focus our analysis.

Potential sources of harm

4.1. Our five potential sources of harm are based on those set out in the CC's standard guidelines for market investigations⁴¹. Our initial formulation of the potential sources of harm is based on our understanding of the market, and analysis done previously for Ofgem's Energy Supply Probe and RMR, as well as its ongoing monitoring.

4.2. Below, we identify these five sources. For each, we describe how the potential source of harm may manifest itself in the energy market. We then provide an outline of the work we will carry out to investigate the source of harm and identify features of the market that might contribute to it.

4.3. Ofgem has the principal objective of protecting the interests of existing and future energy consumers and is subject to a range of general statutory duties, including duties to have particular regard to sustainability, security of supply and the interests of vulnerable consumers. Our assessment is focussed on competition. We will consider whether competition in the market is serving all consumers well, including vulnerable consumers. Our assessment will include consideration of how outcomes from market conditions are serving the interests of vulnerable consumers.

Unilateral market power

What is the potential source of harm?

4.4. Unilateral market power exists when a player in the market is able to influence the market (for example by raising prices) on their own.

How might it manifest itself in the energy market?

4.5. In the retail energy sector, there are a number of relevant characteristics that suggest that exercising unilateral market power may be profitable. For example many parts of the sector are relatively concentrated, especially at a regional level, and consumers may not respond strongly to increases in prices by switching to another supplier or reducing their demand, allowing for a profitable increase in price.

⁴¹(CC3 Revised) Guidelines for market investigations: Their role, procedures, assessment and remedies, Competition Commission, April 2013, para 170: http://www.competition-commission.org.uk/assets/competitioncommission/docs/2013/publications/cc3_revised.pdf

How will we investigate it?

4.6. To examine whether the conditions for unilateral market power exist in this market we will look at: national and regional measures of concentration; change in market shares over time, trying where possible to take account of changes in prices; the sensitivity of demand to price; and indicators for whether that power might be being exercised over time.

Weak competition between suppliers

What is the potential source of harm?

4.7. Under some circumstances firms may be able to undermine the competitive process and protect their joint profits by coordinating their behaviour. This does not have to be through direct agreements between firms; it can also occur when repeated transparent interaction between firms allows them to learn about and foresee each others' strategies.

4.8. For coordinated conduct to be possible and sustainable, the market needs to have certain features: there needs to be sufficient transparency of firms' actions; each firm needs to find coordinating more profitable than not coordinating; and the coordinated outcome has to be relatively unthreatened by potential new entry.

How might it manifest itself in the energy market?

4.9. The energy market has many of the characteristics that suggest that coordination may be possible: it is relatively concentrated and has stable demand and supply conditions, with segmentation between customer types, undifferentiated products and transparent pricing.

How will we investigate it?

4.10. To form a view on whether coordinated conduct is occurring and harming the competitive process we need to consider in combination the market structure, the behaviour and practices of firms, and market outcomes. This will give us information about whether the preconditions exist for parties to coordinate, and whether the behaviours and outcomes we see in the market are best explained by coordinated or non-coordinated behaviour.

4.11. In particular, we will look at demand and supply conditions over time, the amount of new entry, how differentiated the products offered are, the impact of regulation, firms' pricing strategies and price and profit information.

Barriers to entry and expansion

What is the potential source of harm?

4.12. As noted above one of the sources of competitive discipline on companies is the potential for new entry or for the expansion of existing suppliers. Any barriers to such entry or expansion can therefore lead to concerns that existing suppliers do not face competitive constraint and that the market is not working as it should be.

How might it manifest itself in the energy market?

4.13. A range of features of the retail energy market present themselves as barriers to entry or expansion. These can be presented as falling into four types: cost related barriers; strategic and structural barriers arising out of decisions by existing suppliers on how they structure themselves and how they compete; weak demand side barriers arising out of low levels of engagement; and switching and regulatory barriers encompassing market design issues and thresholds for compliance with various obligations.

How will we investigate it?

4.14. We will build a picture of the nature and size of barriers to entry by setting out entry and exit of suppliers, as well as price announcements and movements in market share around those times. We will also speak to a wide range of stakeholders about their views of the relative importance of different barriers and the expected efficacy of Ofgem's liquidity reforms and other changes.

Vertical relationships

What is the potential source of harm?

4.15. Integration of upstream and downstream activities in a market, whether through ownership or through contractual arrangements between the parties, can often have beneficial effects but can also be the source of weakened incentives for companies to compete.

How might it manifest itself in the energy market?

4.16. One characteristic of the domestic retail energy market is the presence of six large vertically-integrated companies, serving 97% of the domestic gas and electricity market. This may lead to issues such as untransparent pricing and profitability through the supply chain, cross-subsidy of different products, or barriers to entry or expansion in wholesale or retail markets.

How will we investigate it?

4.17. In assessing the effect of vertical relationships on competition we will consider how liquidity indicators have evolved over time, as well as independent suppliers' ability to access wholesale energy, and independent generators ability to sell energy, on competitive terms. We will examine the extent and effect of a lack of transparency of wholesale prices. We will also consider profitability across the supply chain as well as the trading models and positions of the vertically integrated companies. We will also note the differences in structure between electricity and gas supply chains.

Weak customer response

What is the potential source of harm?

4.18. An engaged demand side consists of consumers that have access to good information about the products they are interested in, can assess that information,

and then act on the evaluation they have made. Whenever this is not the case for a significant number of consumers, competitive discipline on existing suppliers may be weakened.

How might it manifest itself in the energy market?

4.19. Features of the market may mean that it is unnecessarily difficult for many consumers to engage effectively in the market. Ofgem's RMR found that these features may include:

- A large number of tariffs, many of which have complex structures and discount arrangements. This makes the prospect of engaging in the market unattractive for many consumers and means it is often difficult for consumers who do engage to choose the best tariff for their circumstances.
- The provision of complex, incomplete or unclear information by suppliers may result in reduced ability, confidence and inclination for consumers to engage with the market and consider their energy options. Where information asymmetry may exist, when consumers do engage, any decisions may not be good quality decisions.
- Lack of trust and poor supplier conduct which further reduce the confidence of some consumers to engage in the market and could contribute to the permanent disengagement of others.

4.20. This in combination with other market features (such as the large customer base inherited by the incumbent suppliers and their vertical integration) could limit the ability of consumers to find a better tariff and, in turn, limit the competitive pressure on energy suppliers to offer good customer service at efficient cost (and to innovate and improve over time).

How will we investigate it?

4.21. We have a variety of measures of consumer engagement that are regularly monitored. We will look at levels of switching, as well as changes over time in survey results on a range of engagement metrics including consumer confidence in switching tariff or payment method (either between suppliers or with their current supplier).

Profitability

4.22. One approach to the question of whether prices are above competitive levels is to consider the profitability of energy supply and generation. The CC's guidance⁴² states that a situation where profitability of firms representing a substantial part of the market has exceeded the cost of capital over a sustained period could be an indication of limitations in the competitive process.

4.23. Profit levels are a market outcome and not a source of harm or feature of the market. Nonetheless, we will use the evidence from our profitability analysis to

⁴²(CC3 Revised) *Guidelines for market investigations: Their role, procedures, assessment and remedies*, Competition Commission, April 2013, para 170: http://www.competition-commission.org.uk/assets/competitioncommission/docs/2013/publications/cc3_revised.pdf

support our assessment of sources of harm and market features that may adversely affect competition.

4.24. To examine profitability, we propose to undertake three strands of analysis. The first two strands will focus on the profitability of the large vertically integrated suppliers at supply and generation business levels, in order to shed light on the question of whether profits in one or both areas may have been persistently above competitive levels. We will look at patterns of profits over time and between firms and will, where possible, seek to benchmark available data on profit margins to GB and international comparators, and to the cost of capital. The third strand of analysis will consider the profitability of different customer groups and could help to identify those segments where competition may be more or less effective.

4.25. We propose a fourth strand of work to examine patterns of costs over time and between firms. This may inform our view of whether competition is functioning effectively because we would expect vigorous competition between firms to lead to costs being driven down over time to efficient levels.

4.26. Our aim is to come to a view of whether the data is suggestive, or otherwise, of high profits or inefficiency.

5. Next steps

5.1. The framework for the State of the Market Assessment that we outline in this document incorporates stakeholder input from the event we held in early December. We also welcome further stakeholder feedback on the framework described in this document and will consider this feedback as we carry out our assessment.

5.2. We have commenced our analysis, and as part of this next phase we will hold further discussions with relevant parties.

5.3. We will complete and publish this first annual assessment before the end of March 2014. Following this, the three organisations involved in producing this report – Ofgem, the OFT and the CMA – will separately consider next steps.

5.4. Ofgem is also undertaking work to evaluate the policy implemented following our RMR. In January Ofgem plan to issue an open letter on its draft framework for evaluating the RMR. The draft framework will incorporate feedback from the stakeholder event we held in early December 2013, at which a separate session was held to discuss this. Ofgem will publish the finalised Framework for evaluating RMR in Summer 2014, alongside baseline results of new consumer research that is being designed to underpin the framework.