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Date: 17th April 2014

Dear *Dominique*

European Commission's Retail Markets Consultation

I am writing with a brief note on Ofgem's views on the future of EU retail energy markets, as part of our input to your consultation. As well as completing your online questionnaire, we have contributed to the CEER response to this consultation and to the forthcoming ACER 'Bridge to 2025' paper, which will help to inform the policy debate.

As you will be aware, Great Britain has considerable experience of liberalised energy markets over a number of years and Ofgem has worked hard to ensure that competition works for consumers wherever possible. This approach has delivered consumer benefits, although we consider that in some important respects competition is still not working as well as it should. Our recent assessment of the state of competition in the GB market resulted in a proposal to refer the generation and supply markets for investigation by our national competition authorities. This approach goes hand in hand with our recent reforms to increase consumer engagement in the retail market by making it simpler, clearer and fairer.

We share your view that energy markets across the EU and beyond are undergoing significant change and will continue to do so, particularly on the back of the opportunities provided by the widespread roll-out of smart metering. We therefore consider that it is right to be asking how the market might change and what the implications might be for consumers. This will help inform consideration of whether EU retail energy market arrangements need amending in order to unlock the full potential benefits for consumers of these new opportunities.

Our vision for the retail energy market

We support the Commission's efforts to complete the internal energy market. Our vision for the future is of an efficient, dynamic and competitive EU retail energy market that works well for all consumers. This is consistent with the joint CEER/BEUC 2020 Vision for Europe's energy customers, which we helped to develop in 2012. We want to see four main outcomes:

- Consumer participation. Consumers have the information they need to make appropriate choices and have the confidence to switch product and supplier if the service, the offering or the price they are given is no longer the best for them. Where consumers are vulnerable or unable to engage, they should be appropriately protected and not suffer undue detriment.
- Demand-side flexibility. Consumers are able to find products and services that assist them to use energy efficiently and reward them for consumption (or production) patterns that help keep the system or their local network in balance.
- Effective competition. In this market, suppliers are kept on their toes by the threat of their customers switching to better deals with their competitors, including new entrants. This encourages them to: innovate to create products that meet the changing needs of consumers; present complex deals and products simply; keep their costs down; and treat customers fairly, including through continually improving customer service.
- Efficient distribution networks. DSOs help facilitate the development of the retail market and respond to the needs of market participants. They develop new ways of managing distribution networks, with a focus on efficiency and lower long-term costs for consumers. In doing so, they are incentivised to support consumer participation, reward flexibility and facilitate competition.

I hope that this is a vision that we can all share.

The existing EU legislative framework – most notably the Third Energy Package – provides a good basis for promoting the further development of the EU retail energy market. We support the Commission's efforts to enforce these rules. This should help promote more effective competition, for example by removing barriers to entry into national markets. This includes continuing to push for the removal of unjustified price regulation. We also see an important continuing role for national regulatory authorities to promote retail market development.

In going further, we would encourage the Commission to develop an approach based on a shared set of outcomes wanted from the EU retail energy market – along the lines set out in our vision. This could enable significant benefits for consumers, for example by making it easier for firms to operate in multiple national markets across the EU. In doing so, it will be important to ensure that consumers remain adequately protected in ways that are suitable for their national market context. Flexibility to take account of different market circumstances and consumer expectations, with a strong focus on consumer outcomes, will be important if further EU action is to gain public acceptance. We consider that this represents a proportionate approach that is both realistic and achievable in the medium term.

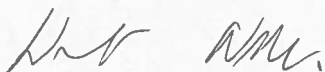
We have found this approach to work well in the past. Examples from the Third Energy Package include the requirement for consumers to have smart meters (where appropriate) and the right for consumers to be able to switch supplier within three weeks. Setting outcomes in this way has enabled Member States to consider how best to achieve them in their circumstances. Given that the energy sector is on the cusp of major change with the rollout of smart metering, we consider that it will be crucial for regulatory arrangements to provide space for firms to innovate in their business models and the products and services they offer to consumers.

We have found that prescriptive rules set out in EU legislation can be problematic. An example is the requirement in the Energy Efficiency Directive to show on bills consumers' usage compared to the same period in the previous year. While we support the aim of giving consumers the right information to make choices, there may be more effective ways for this to be presented. This is particularly likely as more detailed consumption data becomes available from smart meters, with the danger that prescriptive rules will prove inflexible and mean that consumers do not benefit from innovation.

Finally, I would like to share some other reflections on the GB experience. These are set out in an annex to this letter. My colleagues can follow up with your officials on any further queries you might have.

I look forward to working with you as the Commission develops its thinking on the way forward.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Dermot Nolan', written in a cursive style.

Dermot Nolan
Chief Executive Officer, Ofgem

cc Lord John Mogg

Annex: The GB experience

Ofgem has significant experience of making markets work well for all consumers. Moves to open the GB retail energy market to competition began almost 25 years ago and we removed all retail price controls in 2002. We recognise that there are various different models for retail market design across the EU and those markets are at different stages of development. We would not suggest that our model is right for all Member States. Nevertheless, we have learned some useful lessons from our experience, which may be of interest in considering future EU retail market development.

1. Even in mature energy markets, competition issues need ongoing attention, with both demand and supply side barriers identified and tackled

A key lesson from our experience is that, even in a relatively mature retail energy market like GB, competition needs nurturing to ensure that it remains effective. In doing so, we have found it particularly important to consider the demand side as well as the supply side. As elsewhere in the EU, we have seen falling consumer trust in the gas and electricity markets in recent years. This has contributed to falling consumer engagement in the market, which in turn has reduced the competitive pressure on energy suppliers. Other Member States could face similar issues in due course.

We have recently put in place a number of remedies to improve competition in the GB market. These include our Retail Market Review reforms designed to make the market simpler, clearer and fairer for consumers. These changes followed extensive consumer research and consultation to help us better understand consumer attitudes and needs, and to design policies appropriate to the challenges we face. We have also put in place reforms to increase liquidity, which aim to help independent suppliers to access the wholesale products they need. These measures should improve competition in the market. However, our recent State of the Market report concluded that action may be necessary in order to address any further barriers that are preventing competition from bearing down as hard as possible on prices. We have therefore proposed to ask the UK competition authority – the Competition and Markets Authority (CMA) – to undertake a comprehensive review. This should help restore consumer confidence in the working of the market.

The roll-out of smart metering will be an important enabler of retail market development and better outcomes for consumers. By 2020, all homes in GB should be fitted with smart meters. A CMA investigation will help ensure that there are no further barriers that prevent consumers from making the most of the transformation smart meters will bring to the energy market.

2. A well-functioning retail market requires effective systems and processes

Another important lesson we have learned is the need to have in place effective systems and processes to underpin the retail energy market. These are fundamental for delivering a good consumer experience, enabling competition and unlocking the potential from flexibility. This includes enabling timely settlement of energy supply volumes based on actual consumption and supporting reliable, fast switching between suppliers. In respect of the latter, our aspiration is to reduce the switching period to one day from the three weeks set out in the Third Energy Package. This may be the sort of development that could help promote competition across the EU in future.

3. Interventions should be founded on a strong evidence base which takes account of consumer diversity

Our strong consumer evidence base is particularly valuable in helping us as the national regulatory authority to nurture the development of the retail market. Our Retail Market Review was underpinned by 20 consumer research projects, for example, using a wide range of methods (quantitative, qualitative, deliberative and testing) and looking at the experiences of both domestic and business consumers. Some of our research projects have a particular focus on people in vulnerable situations.

More generally it is important to understand that there is no single consumer, as different households and businesses will have diverse experiences, attitudes and types of behaviour. This has a bearing on the nature of our interventions, and we have recently enhanced our approach to distributional analysis as part of our Impact Assessment process.

4. Engaging consumer organisations

We seek to engage effectively with consumer groups – including those representing business customers – to inform our regulatory agenda, build our evidence base on specific interventions, test our thinking and monitor outcomes. Our techniques include: regular meetings with individual organisations, the creation of joint industry and consumer representative advisory groups on particular work areas, and ensuring consumer groups have seats on key industry panels. The Commission could usefully consider whether to support national regulatory efforts to build the capacity of consumer groups.

5. The framework for network regulation should focus on outputs and providing the right incentives for companies to innovate

We have reviewed our approach to network regulation and examined best practice elsewhere so that we have the right framework for the challenges in the energy sector. The new framework, known as 'RIIO' (Revenue = Incentives + Innovation + Outputs), aims to drive real benefits for consumers while providing companies with strong incentives to meet the challenges of delivering a sustainable energy sector at a lower cost.

We have completed RIIO price controls for electricity transmission and for gas transmission and distribution. We are currently undertaking the electricity distribution price control review (RIIO-ED1). We have already seen benefits in the quality of business plans, in costs and in changes in behaviour.

Innovation is important for network companies to deliver at efficient cost. To encourage distribution companies to test innovative projects that move us towards a low-carbon economy, we have established annual innovation competitions, starting with the Low Carbon Networks Fund. The fund offers payment to test projects that would give consumers the biggest financial and carbon benefits.

6. The right regulatory tools

As a statutory body that can go as far as, but no further than, the role Parliament has given us, it is critical that Ofgem has the right regulatory tools. This includes powers to monitor and, importantly, enforce compliance with regulatory requirements on DSOs and suppliers. Our ability to impose penalties where we find breaches of the rules helps protect consumers' interests and promote well functioning markets, by promoting compliance and ensuring companies treat consumers fairly.

We are currently undertaking a review of our approach to enforcement, with a view to maximising the impact and efficiency of enforcement work. We have also recently announced that we will substantially increase the level of penalties we impose for breaches coming to light in the future. For example, only last week we required the largest supplier in the GB market to pay £5.6 million in redress and penalty due to errors in their switching and contract renewal processes.