

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



Executive summary

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1. Ofgem's consultation on a proposal to refer the GB energy market to the Competition and Markets Authority (CMA) comes at a critical time for the sector:
 - Largely because of price increases, trust in the sector is low¹. These rising prices have been driven by increases in commodity costs, network charges and government policy costs which, together, make up around 85% of the typical British Gas dual fuel energy bill. With further upward pressure on costs, a full and frank debate, with transparency from all parties, is needed to restore trust.
 - At the same time, political and regulatory uncertainty have heightened investment risk, just when major investments are needed to secure efficient energy supplies for the future². Unless a normal investment climate is restored, new entrants will be deterred and consumers will suffer in the longer term.
 - The retail market is undergoing regulatory reforms and, most importantly, is also on the threshold of a series of major innovations. Smart metering, for example, will transform customers' engagement with energy, and fundamentally alter the nature of the retail market.
 - Finally, we recognise there was a focus on increasing levels of profitability in the retail sector. However this follows a period in which profitability was very low and we believe profit levels will prove to be entirely reasonable when judged fairly and objectively.
2. It is in this context that Ofgem's proposal to refer the sector to the CMA should be viewed.

¹ See, for example, YouGov: Utilities key drivers of retention" (2012), which found that "dissatisfaction with energy suppliers is strongly related to rising energy bills", page 13.

² https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/261604/HC_675_updated_accessible.pdf

3. We believe that, provided it has comprehensive scope, a rigorous and independent assessment of the state of competition in the sector conducted by the CMA can help to restore market confidence both for consumers and investors (without which competition will be less effective). In particular the CMA's investigation must take account of all the determinants of retail price movements – including the impact of commodity costs, network charges and government policy costs on bills. This will be necessary if the CMA is to truly understand energy market dynamics, and the behaviour of all market participants, including customers.
4. However, such an investigation alone will not address some of the causes of low customer trust and dissatisfaction. For this reason, we are in parallel pressing for greater scrutiny of network charges, and also of whether energy bills are the appropriate way of paying for the escalating cost of government environmental and social policy. In particular, network charges have escalated considerably in recent years, rising 41% in the last six years, and now represent over 20% of energy bills.
5. We believe that competition in the energy market continues to deliver benefits for consumers. Competition between suppliers to serve customers is fierce, delivering some of the lowest retail energy prices in the European Union for GB consumers. Smaller suppliers are now an established and effective competitive force in the market (with 25 different suppliers now active in the domestic retail market), augmenting already effective competition between larger players. Increases in levels of switching in late 2013 have had a material impact on market shares.
6. We would also hope that the investigation will deliver clear and objective measures of success. Confidence in the sector and engagement more widely is more likely to return to the sector if consumers (and stakeholders more broadly) have a clear understanding of what defines a successful market.
7. The CMA's assessment of competition will need to take full account of both very recent and prospective market developments which will significantly affect the market. These include not only measures introduced through the recently concluded Retail Market Review, but also the competitive implications of new technologies such as smart metering. British Gas is at the forefront of a range of innovative initiatives, which are already starting to deliver material benefits for consumers. Smart metering should radically increase levels of customer engagement in both the short and medium term (with 1.6m smart meters installed already⁴). Industry initiatives are also expected materially to reduce switching times by the end of 2014, further increasing competition for customers in the market. It is vital that in the course of the Reference, the CMA assesses the scale and expected impact of innovation, and its competitive impact.

³ http://www.acer.europa.eu/Official_documents/Acts_of_the_Agency/Publication/ACER%20Market%20Monitoring%20Report%202013.pdf

⁴ 1,063,284 smart meters installed across the market in domestic properties and 529,178 installed in non-domestic properties at the end of 2013.

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/289132/Statistical_Release_Smart_Meters_Great_Britain_quarter_4_2013.pdf

The scope of the proposed Reference needs to be sufficiently wide to address all issues that affect competition and consumer behaviour in the market

8. The remainder of this response sets out our views on the consultation document and the State of the Market Assessment in more detail. Specifically:
 - the scope of the proposed Reference needs to be sufficiently wide to address all issues that affect competition and consumer behaviour in the market;
 - the energy market is more dynamic than the Assessment might suggest;
 - the Reference must consider fully the impact of regulation and government policy on the sector;
 - the Reference must take into account the importance for competition of innovation and change in today's energy markets;
 - we agree that vertical integration brings considerable efficiency benefits; and
 - we have a number of additional observations on analysis presented in the Assessment.
9. The CMA, guided by its statutory duties, will have an objective of assessing the extent to which competition is effective in the energy market. It will therefore need to investigate the reasons why customers have a lack of confidence in the way the market operates, and establish the root causes.
10. Recent survey evidence has suggested that one of the most significant drivers of a lack of customer trust in the energy sector is rising prices, which place "severe strain"⁵ on the relationship between energy suppliers and customers and clearly affects consumer behaviour. Given the impact this has on effective competition, we would expect the CMA to examine the reasons why energy prices have been increasing.
11. In this context it is important to recognise that the majority of energy costs relate to commodity costs, network charges and environmental and social policy costs. Taken together, these categories of cost represent around 85% of energy bills – all of which have been on an increasing trend in recent years, with major implications for retail prices.
12. We recognise that, given the proposed terms of reference, the CMA may not be asked directly to assess whether the way in which Ofgem regulates the networks is appropriate, nor whether government policy on environmental and social schemes best serves the interests of consumers. However, given that these cost drivers are critical to understanding the level of energy bills, the CMA will need to examine how they impact both supplier and consumer behaviour in the market, as well as the prices consumers pay.
13. We would also suggest that an aspect of vertical integration which a comprehensive analysis should include is whether ownership of networks by energy suppliers results in any distortion of competition (e.g. by blunting the incentive to press for network charges that represent value for money for consumers).
14. The Assessment raises questions about the effectiveness of industry governance processes, suggesting these may not be acting in a way that is fully in the interests of consumers. We do have some concerns in this area, particularly over whether the composition of voting panels for the most important industry Codes is delivering industry arrangements that are in the best interests of domestic customers. We would welcome CMA focus on this issue in the course of the Reference.

15. We would also expect the CMA to look at the process by which changes in costs relate to movements in retail prices. Given such a large proportion of the energy bill is only partially influenced by energy suppliers, it is to be expected that the retail prices of suppliers will tend to move at similar times in response to significant shifts in these costs. This is not tacit co-ordination, but competing companies reasonably responding to changes in their cost base.
16. It will be important, in understanding the economic context of energy supply, for the CMA to look in detail at whether competition is effective in the generation market. While we believe that the generation market is competitive, we think it right that the CMA should seek to independently assess concerns expressed by Ofgem in the Assessment – in particular, whether a given generator could be able to unduly influence the level of wholesale prices.
17. The Assessment is correct to identify that government policy and regulation have important impacts on supplier behaviour and hence on competition. It is therefore important that the impact of existing policy and regulation on competition in the retail market is considered as part of the CMA's investigation. It is also highly relevant that many of the licence changes resulting from the RMR were specifically designed to resolve issues identified regarding customer engagement (e.g. introduction of Standards of Conduct), yet many of these have only recently come into effect. An element of prospective analysis will therefore be required.
18. We also consider that, within the retail sector, the effect of Third Party Intermediaries (TPIs) such as switching sites should be considered within any Reference. TPIs have a range of impacts on competition in the market today and it is important to consider the impacts, whether pro-competitive or not, that TPIs have on the market. TPIs are beneficial for competition in that they help increase consumer engagement. However, less helpful is a lack of transparency over some TPIs' commission rates and apparent inconsistencies in the quotation models of some sites.
19. Finally, we note the intention for the investigation to encompass a review of the smaller end of the non-domestic retail market (i.e. for micro business customers). This market is structurally very different to the domestic market. For example, the majority of contracts are fixed-term, fixed price and are negotiated bilaterally (very different from the domestic market which is dominated by published tariff offerings). A further key difference is the role that brokers (TPIs) fulfil in the micro-businesses segment where, unlike in domestic, they can facilitate micro-businesses to access the market in a more sophisticated way. The CMA will need to take full account of these differences in its investigation.

The energy market is more dynamic than the Assessment might suggest

20. We would also note that indicators of effective competition for this market segment are particularly strong. The market is typified by an even wider number of suppliers than the domestic market (many of whom specialise in non-domestic supply), and new entry by a number of large companies (e.g. Gazprom). There is also considerable recent analysis (including studies by Ofgem⁶ and independent sources⁷) which supports this view, and which concludes that the market is delivering efficient outcomes for micro business customers.
21. We believe that the Assessment understates the extent of competition in today's retail market. There is demonstrably a breadth of competitive pressure across the market, with 25 suppliers active in the domestic market, and 31 suppliers active in the non-domestic segment (as well as 11 accredited switching sites)⁸. These suppliers serve a wide range of customer needs. Examples include suppliers who focus on providing a 'low-cost', basic, service, those focussing on providing smart meter only offerings, low carbon energy suppliers, those providing services for specific customer groups such as landlords, as well as co-operative business model brands.
22. Competition across the market as a whole continues to deliver value for consumers, exemplified by favourable comparisons to international energy markets. When compared to markets in Europe and globally, the GB market continues to have amongst the lowest retail prices and highest rates of switching. Ofgem has also recently confirmed its view that the GB energy market is among the most transparent in Europe. We would note that Centrica prides itself on being the most transparent energy company in the sector, for example, including voluntary information on power trading results in our Consolidated Segmental Statements (CSS), and the fact that these are fully audited and published at the same time as our Preliminary Results.
23. The number of new suppliers entering the market is also increasing. Since 2009 the number of domestic suppliers has risen from around 11 to 25, while the number of non-domestic suppliers is now at a record high⁹. In the last four years, small supplier domestic market share has risen from 0.17% to 5.40%¹⁰. Four of these small suppliers¹¹ have grown to a sufficient size so as to be considered 'large' for the purposes of regulations such as the Warm Home Discount (WHD) and Energy Company Obligation (ECO). This appears to be an enduring change in market structure, with these suppliers continuing to take market share from more established large suppliers. uSwitch research supports this, noting that 72% of consumers would now switch to a small supplier (up from 56% last year)¹².

⁶ The Retail Market Review – Final non-domestic proposals, Ofgem (22nd March 2013). See, for example, paragraph 1.7.

⁷ See for example Competition in British business energy supply markets, Cornwall Energy (April 2014).

⁸ Numbers sourced from Cornwall Energy.

⁹ <http://www.energy-uk.org.uk/publication/finish/5-research-and-reports/>

1061-cornwall-energy-competition-in-british-household-energy-supply-markets-report-march-2014.html

¹⁰ Cornwall Energy report for British Gas (note that this treats Utility Warehouse as a small, independent supplier in 2014)

¹¹ Ovo Energy, Co-operative Energy, Utility Warehouse and First:Utility.

¹² <http://www.uswitch.com/media-centre/2014/04/as-ovo-drops-prices-three-quarters-of-consumers-would-now-switch-to-an-energy-supplier-outside-of-big-six/>

**The Reference
must consider fully the
impact of regulation and
government policy on
the sector**

24. We also find it encouraging that customer awareness of the ability to switch is consistently shown to be high among consumers (as is evidenced by Ofgem's own figures). Combined with the rise in prominence of switching sites, and the likely positive effect of a number of measures being introduced through the RMR, we believe that customers' ability to access information on energy propositions and identify the best offer for them is only likely to increase further. Many customers also engage by switching tariff while staying with the same supplier – a practice encouraged by our tariff checker (in which we advise customers of savings that can be made by switching to another of our tariffs). It is important to remember that, unlike most other markets where switching is an issue, energy customers who are not on dual-fuel deals have existing relationships with two energy suppliers – for gas and for electricity – both of which would like also to supply the other fuel to the customer. British Gas would certainly like to win electricity custom from its gas-only customers, and competes with the aim of doing so.
25. While it is important to recognise that switching rates are only one of a range of indicators of consumer engagement and effective competition, increases in rates of switching in late 2013 continue to have a sustained impact on market shares. Smaller suppliers are compounding this effect as a growing competitive force in the market.
26. We have already stressed the importance of the CMA's analysis of retail pricing taking full account of the effects of regulation on costs throughout the energy supply chain. In addition, we suggest that the CMA should pay particular attention to whether regulatory interventions intended to improve market performance might nevertheless have had detrimental effects on competition.
27. Questions that could usefully be investigated in this context include the following:
- have measures such as CSS, aimed at promoting competition through increased transparency, created conditions in which behaviours resembling tacit co-ordination are more likely?
 - did the ban on in/out-of-area pricing differentials blunt suppliers' incentives to compete out-of-area?
 - has tariff simplification limited some dimensions of competition, and promoted a degree of homogenisation of supplier offerings?
 - has pressure to end doorstep selling had the effect of reducing consumer awareness of switching possibilities to the detriment of competition?

28. The CMA's investigation will also need to assess the impact of changes introduced following the RMR on competition. This three year review resulted in a wide range of new supplier obligations, all designed to promote consumer engagement in the energy market (through making the market simpler, clearer and fairer). Many of these measures are only just taking effect, yet are expected to have a material impact on customer engagement and hence competition. We also note that, at the time these were implemented, Ofgem stated an intention to review the effect of the RMR changes by 2017, allowing sufficient time for their impact to work through¹³.
29. A range of other more specific regulatory changes have also had a material impact on supplier behaviour. For example, Ofgem requires suppliers to provide at least 30 days advance notice of any price increase¹⁴ (which explains why notifications of price changes now occur well ahead of these changes taking effect – a practice commented upon in the Assessment document)¹⁵.
30. We also believe that regulation may have acted in the past to depress (or ban) price differentials between tariffs, with the consequence that the benefits from switching were reduced, as well as blunting suppliers' incentives to compete with each other. Specifically, Ofgem's prohibition on both in and out of area price differentials in 2009 reduced the incentives for incumbent suppliers in one region to compete against incumbents in others, and also reduced incentives on consumers to switch. It is notable that the introduction of these regulations coincides with the point in time that consumer switching began to decline.¹⁶
31. The Reference should also recognise that consumer groups have been an important driver for changes in recent years, and have had a material impact on supplier behaviour. The most notable example of this was a Consumer Focus campaign to end doorstep selling by suppliers, on the basis of consumer feedback¹⁷. This ultimately resulted in all of the largest suppliers ending unsolicited doorstep selling. Although this was driven by a desire to respect customer preferences, this move did lead to a step-change reduction in switching rates.
32. In recent years suppliers have also responded to a range of specific voluntary initiatives driven by government and Ofgem. An example of this is the set of commitments announced by the Deputy Prime Minister in April 2012¹⁸, and a range of other industry codes and commitments made in response to specific political and regulatory pressures. Examples include treatment of direct debits and vulnerability, and current initiatives focused on credit balances and self disconnection. While these interventions have tended to be positive for consumers, they necessarily require implementation of similar initiatives at similar times by all suppliers, promoting a degree of homogenisation in suppliers' service offerings.

¹³ <https://www.ofgem.gov.uk/ofgem-publications/39350/retail-market-review-final-domestic-proposals.pdf>, page 12.

¹⁴ Supply Licence Condition 23.4.

¹⁵ State of the Market Assessment, paragraph 4.68.

¹⁶ State of the Market Assessment, figures 28 and 29.

¹⁷ Consumer Focus research from July 2011 concluded that only 4% of people were "positive about energy door step sales."

¹⁸ <http://www.consumerfocus.org.uk/news/end-of-the-road-for-cold-call-energy-doorstep-sales-%E2%80%93-says-consumer-watchdog>

¹⁸ <https://www.gov.uk/government/news/government-and-energy-suppliers-reach-agreement-to-help-consumers-get-best-deal>

The Reference must take into account the importance for competition of innovation and change in today's energy markets

33. A major benefit of competition for consumers is innovation in the market. Major changes are under way and anticipated in the market in the very near future. The rate and nature of change and innovation seen today will have a profound impact on the market and nature of competition in coming years, and should therefore form an important part of the CMA investigation into the market.
34. The roll-out of smart meters to every home and business in Great Britain is a prime example, and will deliver benefits directly to consumers such as faster switching and eliminating estimated bills. Smart meters have also been shown materially to increase consumer engagement, a key concern expressed in the Assessment. We also expect smart meters to act as an enabling technology, supporting the development of future innovations in the market.
35. The roll-out of smart meters is not just a regulatory obligation; smart meters are being installed early by British Gas because of competition to keep existing customers and win new ones. Beyond this competitive effect, research also suggests that smart meters will help save the average household around 5% on their yearly bill¹⁹, helped by Smart Energy Reports which provide customers with the ability to see when and how they're consuming energy, together with personalised energy saving hints and tips. Smart prepayment meters have the potential to further promote competition through increased engagement.
36. We are also investing in ways to both help customers harness smart meter data and give them more control of their energy usage, for example through the launch of products like Hive²⁰ (which enables the remote management of heating and hot water).
37. Innovative new tariffs are also being developed to drive the take-up of new technology by customers. British Gas is currently trialling new products such as "Free Saturdays" in order to maximise the consumer benefit gained from smart metering, and we see this as a way of creating competitive differentiation in the market. The impact of the innovation and change is therefore central to assessing the state of competition in the market both today and in future.
38. Innovation and change is also happening at an industry level, for example through suppliers working together to improve the change of supplier process for consumers. This is being done by both increasing the speed at which consumers can switch supplier, and improving common industry processes to improve consumer experience and reduce costs. It will be important for the CMA to examine the full extent of this innovation and change, and its implications for the workings of competition to the benefit of customers today and in the future.

¹⁹ The Value of Smart Metering to Great Britain, Oxford Economics, 20 September 2012

²⁰ See <https://www.hivehome.com/>

We agree that vertical integration brings considerable efficiency benefits

39. Vertical integration is a rational business model which has emerged over time as an efficient way of managing the risks inherent in energy markets²¹. It brings considerable efficiency benefits, as recognised in the Assessment document.
40. Vertical integration does not, however, necessarily reduce liquidity in wholesale markets. Centrica, for example, chooses to optimise overall value by managing its generation and supply businesses as standalone entities, each of which interact with the wholesale market, and thus contribute to overall liquidity. This is demonstrated by the fact that our levels of self-supply are low, just 14% in electricity last year.
41. It is also important to recognise that a degree of self-supply can be efficient. Even a vertically integrated company with much more self-supply than Centrica will need to be active in the wholesale markets in order to shape the output of its generation assets to the shape of its customer demand.
42. We see no evidence of input foreclosure in the generation market. Historical electricity wholesale prices can be well described by short run marginal costs of generators and their input fuel prices and carbon costs. There is also a wide diversity of plant ownership amongst those plant which tend to be price determining.
43. More broadly, other aspects of operating in the market, such as meeting credit and collateral requirements, investing in appropriate IT and billing systems, or complying with relevant regulations are all normal requirements of market participation which suppliers must meet. However, the establishment of smaller suppliers as a competitive force in the market demonstrates that these features are not insurmountable.
44. Finally, we have a number of additional observations on some aspects of the Assessment. We would note that much of the analysis presented in the Assessment, appears to be based on data collected at the start of the RMR investigation – which is now over four years ago. Given that the market has evolved significantly over that time, this suggests a need to re-examine some of the Assessment’s conclusions. This is particularly the case given that the range of measures introduced through RMR has only recently been implemented.
45. A more specific concern relates to Ofgem’s suggestion that British Gas’ gas customers are from its original customer base. In fact, 58% of our gas accounts (8.37m) and 33% of our gas only accounts (0.86m) have been previously supplied by one of our competitors. More generally, the assessment understates the extent to which our gas customers have benefited from competition. 69% of our gas accounts are dual fuel, meaning they have switched away from their original electricity supplier at least once. Even within the segment of gas only customers that have been continuously supplied by British Gas, competition has delivered benefits to customers, with at least 34% of these 1.77m customers switching to a different British Gas tariff, or payment type.

We have a number of additional observations on analysis presented in the Assessment.

Conclusion

46. Similarly, we would dispute Ofgem's suggestion that we are able to segment our customers and charge "legacy" customers higher prices than new customers²². All British Gas' tariffs are open and available to all British Gas customers, regardless of how long they have been a customer. Recent changes in the regulatory framework, introduced as part of the RMR, mean that newly acquired customers do not have access to preferential offers or products.
47. We do not believe that the evidence will support suggestions of asymmetric pricing (i.e. that price increases tend to happen faster than price decreases). Our own analysis, based on both British Gas' own costs and Ofgem's own 18 month hedging strategy model finds no evidence of an asymmetric relationship. We will be happy to share this analysis with the CMA at the appropriate point in the investigation process.
48. We also consider that analysis presented in the Assessment of Centrica's external trading position is incorrect. Any trades we complete on behalf of our 20% stake in existing nuclear power stations are excluded from the analysis, even though the generation itself has been included. It also excludes any activity we conduct on behalf of our proprietary trading business. We believe the impact of self-supply on liquidity is also overstated, given Centrica self-supplies just 14% of its own power requirements²³ and trades the remainder on the open market. Again, we will be happy to share this analysis with the CMA.
49. Finally, we would contest the view set out in the Assessment that competition is not effective enough to efficiently control operational costs²⁴. In our submissions to Ofgem and the OFT earlier this year, we provided evidence that we had taken £600m of cost from our business since 2006, including a variety of restructures, automation, outsourcing and office closures. Competition drove us to do this.
50. Notwithstanding our concerns about the potential implications a referral may have for investment in the UK energy market, we believe that a full and rigorous independent investigation can help to restore confidence in the market both for consumers and investors.
51. For this to provide consumers with the confidence they need that competition is working in their best interests, CMA's investigation must take account of the drivers of this loss of customer confidence – including the impact of commodity, network and government policy on bills. The investigation must also take full account of a range of important market developments currently under way (including measures introduced through RMR, and the competitive implications of new technologies such as smart metering, and changes to industry change of supply processes).
52. We look forward to engaging constructively and comprehensively with the CMA during this process.
53. This response is provided on behalf of the Centrica group of companies, excluding Centrica Storage. It is non-confidential and may be published on the Ofgem website.

²² State of the Market Assessment, paragraph 4.26.

²³ This is the amount of power Centrica self-supplied in 2013.

²⁴ State of the Market Assessment, paragraph 6.37.