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Response to the CMA's Updated Issues Statement

Ofgem referred the energy market to the CMA because we are concerned that competition is not working as well as it could for consumers. We welcome your Updated Issues Statement and broadly agree with your updated theories of harm. We note that you intend to conduct further analysis on these theories of harm in advance of your Provisional Findings and are happy to provide information or expertise in support of this analysis as the investigation continues.

Our views on each of the theories of harm are set out below in turn.

Updated Theory of Harm 1: market rules and regulatory framework in the wholesale market

In general, we agree with the CMA's initial views in relation to the rules that govern the wholesale energy market. In particular, as set out in our submission to you on the wholesale market in December 2014¹, we agree with CMA's initial conclusion that the differences between the GB system and central-dispatch models are relatively minor. Consequently, there are not significant benefits of alternative market designs for supporting effective competition.

We also emphasise that wholesale markets are complex and their fundamentals are changing. In the coming years, the Government's Electricity Market Reforms (EMR), the changing energy mix and greater integration with Europe will all have a significant impact on the characteristics of the wholesale market. The market rules must be considered with these changes in mind. We continue to work with DECC, industry and other parties to ensure that these interrelated developments are considered holistically, including through our Future Trading Arrangements work stream.

As part of its consideration of this first theory of harm, the CMA has raised questions about the cash-out reforms we have proposed under the Electricity Balancing Significant Code Review (EBSCR), in particular their interactions with the Capacity Market under EMR. We believe our proposed reforms to cash-out are necessary even with the Capacity Market in place to ensure that the wholesale market properly reflects the value of energy and provides the right signals for investment in flexibility. We worked closely with DECC to ensure the design of the EBSCR reforms is complementary to the Capacity Market. The risk of over-rewarding generators is reduced by the compatibility of the two mechanisms, as

¹ Available at: <https://www.ofgem.gov.uk/ofgem-publications/91951/assessingthewholesalemarket.pdf>

well as the presence of effective competition in both the wholesale electricity market and the Capacity Market.

Finally, we note the CMA's interest in locational pricing in the wholesale electricity market. We agree that options for improved locational pricing should not be ruled out as a tool for improving the price signals provided to the market. It is worth noting that locational signals can be provided through a range of channels, including Balancing Services Use of System (BSUoS) charging, losses, transmission charging and the separation of the market into different bidding zones ('market splitting'). In terms of market splitting, the European Capacity Allocation and Congestion Management (CACM) guideline requires us to monitor the wholesale electricity market and to initiate a review of alternative bidding zones should we believe there is a case. We are happy to provide further information to the CMA on this process if it would be helpful.

Updated Theory of Harm 2: market power in generation leads to higher prices

Wholesale electricity market

We agree with the initial view put forward by the CMA that there are not significant issues associated with market power in the wholesale electricity market. We will provide the CMA with our most up-to-date analysis in this area to assist with considering this theory of harm.

We remain vigilant in monitoring the market for abuses of market power, for example, through our Transmission Constraint Licence Condition (TCLC) and our powers under REMIT².

Wholesale gas market

In the Updated Issues Statement, the CMA states that it does not see evidence of harmful features in the wholesale gas markets. We agree with this view, as well as the CMA's statement that this does not necessarily imply that there are no problems in the retail gas market³. Again, we will continue monitoring the wholesale gas market and will be prepared to act if we identify any problems.

Updated Theory of Harm 3a: opaque prices and low liquidity in wholesale electricity markets

We agree with the CMA's initial view that there are signs of improving liquidity in the wholesale electricity market. As outlined in our wholesale market submission⁴, we note that liquidity should be measured against a wider definition than quantitative indicators such as churn and bid-offer spreads alone – the key issue is the ability of all players in the market to access the wholesale market products they need. Ofgem's Secure and Promote licence condition could help to underpin this availability. We will continue to monitor the market and, in particular, the effects of Secure and Promote. If we find that liquidity is insufficient to support effective competition we will take further action.

Updated Theory of Harm 3b: vertical integration

Vertical integration is one of the key issues we asked the CMA to consider when we referred the market and we welcome the CMA's initial views on this issue. In formulating its Provisional Findings, we encourage the CMA to come to a definitive, evidence-based finding on the compatibility of vertical integration and competition in energy markets. We believe the CMA's cross-sectoral experience may be particularly helpful in this area.

² When considering the application of the TCLC and REMIT Ofgem also considers the possible application of competition law and whether proceeding with an investigation and potential enforcement action under competition law would be more appropriate.

³ As noted above, we are happy to provide up-to-date analysis to support the CMA in its analysis of this issue.

⁴ Available at: <https://www.ofgem.gov.uk/ofgem-publications/91951/assessingthewholesalemarket.pdf>

Updated Theory of Harm 4: competition in the retail market

Our concerns about how well competition functions in the retail energy market were the principal reason for our referral to the CMA. We therefore support the CMA's indication that the retail market is a key focus of the next phase of its investigation. We note the CMA's statement that its views on this theory of harm are at an earlier stage of development and will evolve as its analysis progresses. To assist, we will continue to provide the CMA with any data and analysis that may be relevant as it becomes available, including our report on the retail energy market expected this summer.

We agree with the CMA's identification of historical incumbency as a key impediment to effective competition in the retail market as part of Theory of Harm 4. As outlined in our submission to the CMA on this issue⁵, we are concerned that the combination of the large number of inactive consumers in the retail market, the disproportionate share of such consumers held by the incumbent suppliers and the ability of suppliers to segment the market between active and inactive consumers weakens competitive pressure on incumbent suppliers and creates barriers to entry and expansion for independent suppliers.

Ofgem actively monitors and assesses the functioning of the retail market. We have introduced a number of measures to address the problems we have identified, to protect consumers and to improve competition. We agree that the investigation should consider the impacts of such regulatory interventions and we are keen to learn any lessons this evaluation reveals. Many of the problems identified by the CMA under Theory of Harm 4 are long-standing and pre-date the specific regulatory interventions identified in the Updated Issues Statement⁶. We believe these longstanding issues should be the key focus of the CMA's assessment of the retail market.

The CMA has identified several areas in the retail market where it will undertake further analysis. Areas we believe would, in particular, merit further consideration by the CMA include: barriers to switching and engagement, the role played by third party intermediaries (such as price comparison websites and brokers in the non-domestic market) and the level of competition in the market for microbusinesses. We are happy to support this further analysis wherever possible.

Similarly, there are areas of the retail market where we are already undertaking work which we believe will address some of the concerns raised by the CMA – for example settlement and the implementation of smart meters. We intend to continue to work with DECC and other parties to ensure that these longer-term market developments support effective competition. We are happy to provide the CMA with further information on our work in this area.

Updated Theory of Harm 5: the regulatory framework and code governance system

We welcome the inclusion of this new theory of harm focussed on the regulatory framework and in particular the current code governance system. As outlined in our submission to the CMA on Codes Governance⁷, we believe there are a range of issues in this area which act as a barrier to effective competition, particularly for new entrants, smaller players and new business models.

While we acknowledge the length and complexity of the codes, our concerns are focused on whether the current system of code governance acts as a barrier to pro-competitive innovation and change. We believe that addressing this problem can deliver significant benefits for consumers.

⁵ Available at: <https://www.ofgem.gov.uk/ofgem-publications/92601/cmasubmissionincumbency.pdf>

⁶ For example, our Energy Supply Probe in 2008 noted the significant proportion of consumers who did not engage effectively in the energy market. See: <https://www.ofgem.gov.uk/ofgem-publications/38437/energy-supply-probe-initial-findings-report.pdf>

⁷ Available at: <https://www.ofgem.gov.uk/ofgem-publications/92627/cmasubmissioncodegovernance.pdf>

Within our existing powers, we have already sought to address some of these issues through our Code Governance Review, the first phase of which we completed in 2010. We have committed to conducting a post-implementation review and plan to launch this in the coming months. As part of this review we will also consult on wider governance issues – for example, whether the Significant Code Review process can be enhanced.

We are aware that there may be reforms that could improve code governance which are beyond our existing powers. We welcome the CMA's views on the problems faced by the code governance regime and will be happy to share our thoughts on the measures that could be taken to address them.

In terms of the broader regulatory regime: we will consider making greater use of principles-based regulation (ie regulation that defines the outcomes we want to see delivered, rather than prescriptive rules). Our Standards of Conduct in the retail market are one example of this approach. In the coming months we will take forward our thinking on principles based regulation, starting with a process of stakeholder engagement.

Under this theory of harm, we would also encourage the CMA to consider the legislative framework within which Ofgem operates. We welcome the CMA's thoughts on whether Ofgem's regulatory duties are sufficiently clear to guide our regulation of the market, as well as our interactions with other bodies in the energy policy sphere.

Concluding remarks

We are committed to playing a full part in the investigation to ensure the market delivers benefits for consumers. The Updated Issues Statement represents an important step in the progress of this investigation and we welcome the CMA's updated theories of harm. We will continue to assist the CMA by providing information, data and expertise wherever it is helpful and in line with our statutory functions. We are happy to discuss any of the matters raised in this response as the investigation progresses.

Yours sincerely,

Emma Kelso
Partner, Markets