

Discussion Paper

Developing a framework for assessing whether conditions are in place for effective competition in domestic supply contracts

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Overview

We are seeking views from stakeholders on our proposed framework for assessing whether conditions are in place for effective competition in the domestic energy retail market. This is for the purpose of recommending to the Secretary of State whether or not the cap on default and standard variable tariffs should remain in place, as required under the Domestic Gas and Electricity (Tariff Cap) Act 2018.

The cap was introduced because the retail energy market was not working well for all consumers. Consumers on default and standard variable tariffs were paying substantially more than those who shopped around for fixed tariff deals. To protect these consumers, Parliament passed legislation in 2018 for a temporary cap on default and standard variable tariffs. This cap was introduced by Ofgem in January 2019. Alongside this, the government and Ofgem are working towards structural reforms to improve the competitive process in the domestic retail market and outcomes for energy consumers.

With the cap on default tariffs now in place, the Domestic Gas and Electricity (Tariff Cap) Act 2018 requires Ofgem to review whether conditions are in place for effective competition for domestic supply contracts. This review must be published by 31 August 2020 and include a recommendation on whether the cap should remain in place for 2021 or be removed. The Secretary of State will consider this review and make a decision by 31 October 2020. If the default tariff cap is extended into 2021, the process will be repeated in 2021; if the cap is extended into 2022 the exercise will be repeated for a final time in 2022 as the cap will cease to have effect at the end of 2023.

This paper proposes a framework for making that assessment. We would welcome your views on it.

Please send us your views by **12.30pm on 9 July 2019** to Effective.Competition@ofgem.gov.uk

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Context

For the energy market to deliver good outcomes for domestic consumers, competition between energy suppliers must work effectively. Consumers benefit from effective competition through the price they pay for energy, innovative new products and high quality of service.

In recent years, competition in the domestic retail energy market has not worked as well as it should for all consumers. Consumers who were active and shopped around usually found a good deal, but less active consumers tended to be on more expensive default tariffs and were paying much more to meet their energy needs. This “two-tier” market was resulting in poor outcomes for many consumers; and these less-active consumers were on average less well-off, less well-educated and more likely to be in vulnerable circumstances.¹ In response, in 2018, the government introduced legislation to provide temporary price protection to the estimated 11 million households on default energy deals. The Domestic Gas and Electricity (Tariff Cap) Act 2018 (henceforth the Tariff Cap Act) came into effect on 19 July 2018. On 1 January 2019, in accordance with this Act, Ofgem implemented a temporary price cap on the standard variable and default rates charged by suppliers to domestic consumers.

In addition to protecting consumers against unjustified price increases, Ofgem and the government have put in place or are putting in place a range of structural reforms to improve the competitive process and, in turn, the outcomes for domestic consumers. These reforms include the roll out of smart meters to allow consumers to manage their energy use better and save money, as well as a range of other measures such as the faster, more reliable switching programme. Many of these reforms follow from recommendations made by the Competition and Markets Authority (CMA) in its 2016 Energy Market Investigation.²

The cap on default and standard variable tariffs will remain in place until conditions for effective competition are in place or the end of 2023 at which point it ceases to have effect. More specifically, Section 7 of the Tariff Cap Act requires Ofgem to conduct a review into whether conditions are in place for effective competition for domestic supply contracts. This review must be published by 31 August 2020 and include a recommendation on whether the cap should remain in place for 2021 or be removed. The Secretary of State will consider this recommendation and make a decision by 31 October 2020. If the cap is extended into 2021 the same process will be repeated in 2022. Similarly, if the cap is extended into 2022 the exercise will be repeated for a final time in 2022.³

This discussion paper sets out our proposed framework for assessing whether conditions are in place for effective competition. This includes:

- our proposed definition of effective competition and, in turn, our proposed conditions for effective competition; and
- our proposed assessment approach, which includes an assessment of how the competitive market process is functioning and how this contributes to outcomes for domestic consumers. The assessment of how well the competitive process is functioning will involve (among other things) examining the progress of structural reforms and market developments, including the roll out of smart meters (as required by the Tariff Cap Act).

¹ See, for example, the discussion on the CMA database group in: Ofgem (2018), “[Consumer Engagement Survey 2018](#)”.

² CMA (2016), “[Energy market investigation: Final Report](#)”.

³ See Section 8 of the [Domestic Gas and Electricity \(Tariff Cap\) Act 2018](#) for more detail on this process.

Associated documents

Links to other associated documents

- The Domestic Gas and Electricity (Tariff Cap) Act 2018
<http://www.legislation.gov.uk/ukpga/2018/21/contents/enacted/data.htm>

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Executive summary

Background

The domestic retail energy market has not been working well for all consumers, in particular for less-active consumers on default and standard variable tariffs. The government and Ofgem are responding with a number of measures to protect consumers from unjustified price increases and to improve the functioning of the energy market. These measures include:

- A temporary cap on default and standard variable tariffs while the market changes to work more effectively for consumers. The cap sets a maximum price that suppliers can charge customers per unit of energy⁴ as opposed to a maximum bill, which depends on the amount of energy used; and
- A series of structural reforms that aim to improve the way that the retail energy market functions. These include the roll out of smart meters and many of the recommendations that followed from the CMA's Energy Market Investigation in 2016.

The cap on default tariffs was implemented in January 2019 and is in place until 2023 at the latest, but may be removed earlier depending on whether conditions are in place for effective competition in retail energy markets. We are developing a framework to assess whether these conditions are in place. This discussion paper is a consultation on our approach.

What is meant by effective competition

The Tariff Cap Act does not define what is meant by effective competition. In the context of this review, we consider competition to be effective if it involves rigorous rivalry between firms to win and to retain customers, and it results in good outcomes for most consumers in terms of what matters to them (eg price and quality of service).

The conditions for effective competition

Based on our definition of effective competition, we identify three broad conditions for effective competition:

- **Condition 1: structural changes in the market are facilitating or can be expected to facilitate competition**
Structural changes in the market should be developing well: these changes encompass reforms from the government and Ofgem as well as wider market developments.
- **Condition 2: the competitive process is expected to work well in the absence of the cap**
For instance, there should be no unaddressed anti-competitive conduct nor unnecessary barriers to consumers and market providers participating in the market. Consumers must be able to choose confidently and well, and on the supply-side there must be sufficient commercial opportunity to attract entry, innovation and investment.
- **Condition 3: good outcomes for most consumers**
The competitive process should be capable of delivering good outcomes for most consumers, including for those who are less active in the market. Competition will not

⁴ Ofgem (2018), "[Decision – Default tariff cap – Overview document](#)", p. 12.

always deliver good outcomes for all consumers; some protection may be needed for those least able to represent their interests.

These three conditions will be considered “in the round”.

Assessing whether the conditions for effective competition are in place

At a high-level, our proposed framework involves monitoring the progress of structural changes in the market and how these changes affect – or can be expected to affect – both indicators of the competitive process and the outcomes it generates. The outcomes that we propose to consider include the price that consumers pay for energy; differentials in price across comparable tariffs; the quality of service offered to consumers; and the ease and reliability of switching.

We will not set specific thresholds on the indicators that we monitor. Moreover, we will consider these indicators in the round, rather than one-by-one in a tick-box fashion. For example, looking at switching rates on their own does not give you enough information on whether customers are happy with the products and services offered in the market; the switching rates need to be considered alongside other indicators.

We also recognise the difficulty of assessing the effectiveness of competition while the price cap is in place as it affects both competitive dynamics and customer outcomes. We will take a pragmatic approach to this and will make every effort to account for the effect that the default tariff cap may have on the indicators that we monitor, and in particular, whether this impact is likely to be temporary or more long-lived.

Next steps

We want to hear from anyone interested in this framework. Please send your response to EffectiveCompetition@ofgem.gov.uk by 12.30pm on 9 July 2019.

1. Introduction

Chapter summary

In this chapter, we discuss the following:

- the context in which our proposed framework is being developed;
- the requirement on Ofgem, as set out in The Domestic Gas and Electricity (Tariff Cap) Act 2018, to assess whether conditions are in place for effective competition for domestic supply contracts; and
- the structure of the rest of this paper.

1.1. In recent years, the retail energy market has not been working as well as it should for all consumers. Active consumers who shopped around could usually acquire a good deal but less-active consumers on default tariffs would pay substantially more. Government and Ofgem were concerned about this “two-tier” market, which resulted in:

- *a range of structural reforms that are designed to improve the functioning of retail energy markets*, facilitating good outcomes for consumers. These reforms include those from government and from Ofgem, such as the roll out of smart meters and many of the recommendations from the CMA’s Energy Market Investigation in 2016. We expect these reforms to be supplemented by a package of reforms identified through the Future Energy Retail Market Review which is being undertaken jointly with the Department for Business, Energy and Industrial Strategy;⁵ and
- *a temporary cap on standard variable and default tariffs*, which was introduced through the Domestic Gas and Electricity Tariff Cap Act 2018 (Tariff Cap Act) and implemented by Ofgem in January 2019. It protects consumers by ensuring that the price they pay for energy more closely reflects the underlying costs of supply. We expect it to save around 11 million customers £1.1 billion per annum in total.⁶

1.2. The cap ceases to have effect in 2023 at the latest but can be lifted earlier if the conditions are in place for effective competition in domestic supply contracts. Section 7 of the Tariff Cap Act requires Ofgem to carry out this assessment and make a recommendation to the Secretary of State on whether or not the cap should be extended.

⁵ Department for Business, Energy and Industrial Strategy (2019), “[Future Energy Retail Market Review: overview](#)”.

⁶ Ofgem (2018), “[Decision – Default tariff cap – Overview document](#)”, p. 6.

Our requirement to review conditions for effective competition

1.3. The key requirements and timelines for producing the review are stated in Section 7 of the Tariff Cap Act as follows:⁷

“Review of competition for domestic supply contracts

- (1) The Authority must carry out a review into whether conditions are in place for effective competition for domestic supply contracts.
- (2) Such a review must, among other things, consider the extent to which progress has been made in installing smart meters for use by domestic customers.
- (3) Such a review must be carried out –
 - (a) in the year 2020,
 - (b) if the tariff cap conditions are extended to have effect for the year 2021, in that year, and
 - (c) if the tariff cap conditions are further extended to have effect for the year 2022, in that year.
- (4) As soon as practicable after carrying out the review, and in any event on or before 31 August in the year in question, the Authority must –
 - (a) produce a report on the outcome, which must include a recommendation as to whether or not the authority considers that the tariff cap conditions should be extended to have effect for the following year, and
 - (b) Publish the report and send a copy to the Secretary of State.
- (5) After considering the report the Secretary of State must publish a statement setting out whether the Secretary of State considers that conditions are in place for effective competition for domestic supply contracts.
- (6) The statement must be published on or before 31 October in the year in question. ”

1.4. To meet the requirement set out in Section 7 of the Tariff Cap Act, we have developed a framework for assessing whether conditions are in place for effective competition in domestic supply contracts. We welcome your views on our framework and there are details on how to respond in Chapter 6.

⁷ See [Domestic Gas and Electricity \(Tariff Cap\) Act 2018](#), p. 5.

Structure of this discussion paper

1.5. The remainder of this discussion paper is structured as follows:

- in Chapter 2, we provide a high-level overview of the framework that we propose for assessing whether conditions are in place for effective competitive in domestic supply contracts. We also discuss the principles that guide our framework;
- in Chapter 3, we set out our proposed definition of effective competition and, in turn, the conditions that should be in place for there to be effective competition. The conditions focus on how competition should function to deliver good outcomes for consumers;
- in Chapter 4, we discuss our proposed methodology for assessing whether conditions are in place for effective competition. This involves assessing the direction of travel of key indicators to measure how the competitive process is functioning and what outcomes this generates for consumers;
- in Chapter 5, we summarise the next steps for finalising our framework; and
- in Chapter 6 we recap the key consultation questions from the document and how to submit responses. We welcome views from stakeholders.

2. Overview of the framework

Chapter summary

In this chapter, we provide a high-level overview of our proposed framework for assessing whether conditions are in place for effective competition in domestic supply contracts.

- 2.1. We have developed an analytical framework to meet our obligation to assess whether conditions are in place for effective competition. We expect our framework to evolve over time, including to reflect developments in the market and / or lessons learned from each assessment.

Principles guiding the assessment framework

- 2.2. Our proposed framework for assessing whether conditions are in place for effective competition in domestic supply contracts is guided by three key principles:
- **Transparency:** The methodology and decision-making process will be articulated clearly and transparently to stakeholders;
 - **Evidence-based:** The proposed analytical framework will be underpinned by quantitative and qualitative data of the indicators and structural changes that we expect to monitor; and
 - **Practical:** We will make an overall judgement of the likelihood of competition being effective in the absence of the price cap. We will not set specific thresholds, which could prove misleading.

Overview of the assessment framework

- 2.3. We summarise the framework in Figure 1. It defines what we mean by effective competition and specifies the conditions that, if in place, would enable effective competition to develop. It also assesses the development, over time, of key indicators of how well the retail energy market is working and the outcomes that it generates for consumers.
- 2.4. Each of the components of the framework, including the definition of effective competition and the conditions that give rise to it, are discussed in detail in subsequent chapters.
- 2.5. The development of the framework has been informed by:
- the Tariff Cap Act 2018 and Parliamentary discussion about the Bill;
 - the academic and policy literature on the characteristics of competitive markets and the outcomes they should generate for consumers; and

- recent practice in the regulatory and policy spheres, including the CMA’s consultation response to the government’s Modernising Consumer Markets Green Paper.⁸

⁸ CMA (2018), “[Modernising consumer markets green paper: CMA response to Government consultation](#)”.

Figure 1: Overview of proposed framework

PRINCIPLES GUIDING THE FRAMEWORK

Transparent

Our methodology and decision-making process will be articulated clearly and transparently to stakeholders.

Evidence-based

The framework will be based on indicators of consumer and supplier behaviour and indicators on how structural changes to the market are progressing. It will be underpinned by quantitative and qualitative data.

Practical

We will make an overall judgement on the likelihood of competition being effective in the absence of the price cap. We will not set specific thresholds, which could prove misleading or undesirable.

OVERVIEW OF THE FRAMEWORK

1

Defining Effective Competition

In the context of this review, we consider competition to be effective if it involves rigorous rivalry between firms to win and to retain customers, and it results in good outcomes for most consumers in terms of what matters to them (eg price and quality of service).

2

Setting out the Conditions for Effective Competition

The below conditions are not cumulative. They are jointly sufficient but may be satisfied individually to varying degrees.

Structural changes

Structural changes in the market are facilitating or are expected to facilitate the competitive process; these changes include:

- Reforms promoted by government and Ofgem, including the roll out of smart meters; and
- Wider market developments such as automatic switching.

Competitive process

The energy market is expected to work well in the absence of the cap. There should be no unaddressed anti-competitive conduct nor unnecessary barriers to consumers and market providers participating in the market.

Consumers must be able to choose confidently and well, and on the supply-side there must be sufficient commercial opportunity to attract entry, innovation and investment.

Good outcomes

The competitive process should be capable of delivering good outcomes for most consumers, including those who are less active in the market.

Competition will not always deliver the best outcomes for all consumers; some protection may be needed.

3

Assessing the movements in process and outcome indicators

Process indicators (examples)

- *Market structure:* market shares; number of smart meters installed.
- *Consumer behaviour:* switching rates; engagement.
- *Supplier performance:* profit margins.

Outcome indicators (examples)

- Price and price differentials
- Quality of service
- Tariff choice
- Switching process
- Trust and confidence

3. How we define effective competition and the conditions for effective competition

Chapter summary

In this chapter, we set out

- how we propose to define effective competition in the context of our framework; and
- the conditions that would need to be in place for effective competition to develop in domestic supply contracts.

- 3.1. The Tariff Cap Act does not define effective competition, and there is no generally accepted definition in relevant policy frameworks or academic publications.
- 3.2. Our proposed definition and related conditions should be viewed within the context of the requirements under the Tariff Cap Act; that is, to assess whether the price cap on default tariffs should remain in place or be lifted.
- 3.3. The specifics of the Tariff Cap Act, considered alongside the parliamentary debate on the Tariff Cap Bill, mean that we propose a bespoke definition of effective competition in our framework. As such, the definition we propose here is not one we would expect to use in other contexts.
- 3.4. We have drawn on the experience of previous removals of price controls, such as our removal of retail price controls in 2002 and those in the telecommunications and postal sectors between 2002 and 2006.⁹

Literature on effective competition

- 3.5. Despite its widespread use by policymakers, competition authorities and regulators, there is no consistently applied definition of effective competition.¹⁰ In broad terms, there is agreement that effective competition involves rivalry that prevents firms exercising market power. But specific definitions differ across assessments, depending on factors such as market features and consumer and societal concerns.
- 3.6. In economic theory the concept of effective competition can largely be traced back to the theory of “workable competition”, by Clark (1940): it attempts to bridge the gap between the theoretical concept of perfect competition and that which in practice may be desirable when one accounts for “imperfections” such as barriers to the entry and

⁹ See NAO (2008), “[Protecting consumers? Removing retail price controls](#)”, Report by the Comptroller and Auditor General.

¹⁰ Bender, C.M., Gotz, G. and Pakula, B. (2011), “Effective Competition: Its Importance and Relevance for Network Industries”, in “Effective Competition’ in Telecommunications, Rail and Energy Markets”, *Intereconomics 2011*, 1.

exit of firms and partially informed consumers.¹¹ While this work sparked debate, little consensus has followed.

- 3.7. An overarching theme in the literature is the importance of developing a practicable set of conditions for “directing” competition to achieve socially desirable outcomes.¹² These conditions would cover the structure of the market, the behaviour of firms and consumers in the market and the resulting performance of the market in achieving socially desirable outcomes.
- 3.8. Littlechild (2011) argues that a definition of effective competition must fully account for the dynamic benefits of competition, including the development of more efficient methods of production and the discovery of the type of products that consumers want.¹³
- 3.9. Appendix 2 provides some examples of how the term “effective competition” is used by other organisations, such as the CMA and the Financial Conduct Authority.

Our proposed definition of effective competition

- 3.10. For the purpose of this review, we consider competition to be effective if it involves rigorous rivalry between firms to win and to retain customers, and it results in good outcomes for most consumers in terms of what matters to them (eg price and quality of service).
 - Independent rivalry across suppliers to provide innovative products that meet the needs of consumers is central to a well-functioning competitive process. This rivalry is driven by the willingness of consumers to choose the best deal for them in the market, whether directly or through a third party. This rivalry occurs over a wide range of product features, including price, quality of service and branding. There is also rivalry to bring innovative products and services to market.
 - Consumer “outcomes”, refer to a broad set of factors that matter to consumers. These include prices and price differentials but also a range of other outcome indicators such as quality of service, the range of tariffs available, and how easily and reliably customers can change tariffs and suppliers.
- 3.11. Our proposed definition was informed by analytical frameworks we have used in the past, the academic literature, and the practice of other organisations. Reflecting the specifics of the Tariff Cap Act and the parliamentary debate, our approach takes account of a broader range of factors than when retail price controls were lifted in 2002, when we focused on process measures such as consumer switching rates.

¹¹ See Clark, J.M. (1940), “Toward a Concept of Workable Competition”, *The American Economic Review*, Vol.30, No.2, pp. 241-256.

¹² Sosnick, S.H. (1958), “A critique of Concepts of Workable Competition”, *The Quarterly Journal of Economics*, 72(3), pp. 380-423.

¹³ Littlechild, S. (2011), “The Nature of Competition and the Regulatory Process”, in “Effective Competition’ in Telecommunications, Rail and Energy Markets”, *Intereconomics 2011*, 1.

Question 1: Are there any features of effective competition that are not covered in our definition?

The conditions for effective competition

3.12. In this section, we set out the three broad conditions for effective competition that we propose to assess. They are:

- *Condition 1:* structural changes are facilitating or can be expected to facilitate the competitive process;
- *Condition 2:* the competitive process is expected to work well in the absence of the cap; and
- *Condition 3:* competition is expected to deliver good outcomes for most consumers, including those who are less-active in the market.

3.13. These three conditions will be considered “in the round”.

Condition 1 requires that structural changes are facilitating or can be expected to facilitate the competitive process

3.14. Structural changes, including the smart meter programme and related innovations, should be progressing well. This will enable the competitive process to work more effectively.

3.15. Our assessment will consider the progress of a range of structural changes intended to improve the functioning of the retail energy market. These changes come from several sources including government, Ofgem and private companies. They include, for instance, the reforms we and government are bringing in following the CMA’s energy market investigation and the development of new ways of engaging with the energy market, such as automatic switching services.

3.16. Within this wider group of structural changes, we are explicitly required by the Tariff Cap Act 2018 to consider the progress of the smart meter roll out for domestic consumers. Smart meters should facilitate the competitive process by giving consumers near real-time information on their energy use, allowing them to make more informed choices on energy use and ultimately tariffs and suppliers. Smart meters may also facilitate innovation in product offerings in the market.

3.17. Other examples of structural changes may include; automatic switching services in the market and a number of the recommendations made by the CMA following its Energy Market Investigation in 2016.¹⁴

¹⁴ The CMA concluded that the domestic energy market was not working well for all consumers and identified adverse effects on competition, such as weak customers response and price discrimination. It identified a range of remedies to help address these issues. See CMA (2016), “[Energy market](#)”

3.18. In addition, the Future Retail Market Review, which we are doing jointly with the Department for Business, Energy and Industrial Strategy, is identifying a package of reforms to promote competition and drive innovation, while ensuring that all consumers remain protected from harm and can share the benefits.¹⁵ We expect to incorporate any structural reforms proposed by the review into our framework.

Condition 2 requires that the competitive process is expected to work well in the absence of the cap

3.19. The competitive process should be expected to work well, with rivalry between suppliers to attract and to retain customers. There should not be any unnecessary barriers to consumers and firms participating in the market. For example:

- the ease of entry and exit of firms is a desirable feature of competitive markets as it incentivises firms to be efficient, to improve production technologies and to bring innovative products to market. This must, however, be balanced by the consideration that suppliers who enter the market do so with business models that can be sustainable;
- there should be no collusion between firms; abuse of market power or other practices that distort competition;¹⁶ and
- consumers should be readily able to access information on different product offerings in the market, and they should be able to transfer swiftly and reliably from one tariff / provider to another. This is important in ensuring that consumers have confidence and trust in the market.

A well-functioning competitive process in the energy market is also characterised by efficient energy providers being able to finance their operations and make a reasonable profit.

Condition 3 requires that competition is expected to deliver good outcomes for most consumers, including those who are less active in the market

3.20. The competitive process should be expected to deliver good outcomes for most consumers, including those who are less active in the market. Competition will not always deliver the best outcomes for all consumers, and some protection may be necessary.

3.21. As discussed in more detail in Chapter 4, the set of outcomes that we propose to assess include the prices that consumers face, the quality of service that they receive, the range of different products to meet their needs and the ease and reliability of switching energy tariff and supplier. We will assess the potential extent of dispersion of prices in a competitive market, including to judge whether consumers who are less active in the market would face excessive prices.

[investigation: Final report](#)".

¹⁵ Department for Business, Energy and Industrial Strategy (2019), "[Future Energy Retail Market Review: overview](#)".

¹⁶ For further examples see CMA (2017), "[Market Studies and Market Investigations: Supplemental Guidance on the CMAs approach](#)".

- 3.22. Condition 3 suggests that, even in a world where competition delivers good outcomes for most consumers, there may still be groups of consumers that require protection and targeted support. In particular, society may desire better outcomes than would be delivered by the competitive process for consumers in vulnerable situations, such as those with low incomes or disabilities.
- 3.23. Section 9 of the Tariff Cap Act 2018 makes a separate provision for Ofgem to carry out a review to consider whether there are categories of domestic consumers that require protection against excessive charges. This review should consider consumers that may be vulnerable financially or otherwise. We note that these considerations form part of the scope of the Future Energy Retail Market Review that we are undertaking jointly with the Department for Business, Energy and Industrial Strategy.¹⁷ The Tariff Cap Act sets out that the cap must come to an end no later than the end of 2023 and the review will ensure appropriate protections for all consumers in the post-price cap world.

Question 2: What are your views on the conditions for effective competition we have proposed? Are they clear and is there anything else you think we should take into account?

¹⁷ Department for Business, Energy and Industrial Strategy (2019), "[Future Energy Retail Market Review: overview](#)".

4. How we will assess whether the conditions for effective competition are in place

Chapter summary

In this chapter we set out:

- the structural changes we think will play an important role in enabling effective competition;
- some of the indicators of the competitive process and consumer outcomes we intend to use to assess whether the conditions for effective competition are in place;
- the approach we will use to assess the likely impact of the default tariff cap on the competitive process and, in particular, whether these effects are likely to be temporary or more long lasting; and
- the criteria we will use to evaluate whether competition can deliver good outcomes for most consumers, including those who are less active in the energy market.

4.1. In the previous chapter, we set out the following conditions for effective competition:

- *Condition 1:* structural changes in the market are facilitating or can be expected to facilitate competition;
- *Condition 2:* the competitive process is expected to work well in the absence of the cap; and
- *Condition 3:* competition is expected to deliver good outcomes for most consumers, including those who are less-active in the market.

4.2. Our framework will consider evidence on the extent to which each of these conditions is satisfied.

The structural changes we plan to consider

4.3. We have previously acknowledged that conditions in the domestic retail energy market need to improve if competition is to generate better outcomes for consumers on default tariffs.¹⁸ Our framework will consider the progress in implementing structural reforms that Ofgem and government are putting in place to improve the competitive process in the domestic retail energy market. These structural reforms are a combination of demand-side changes, which are aimed at making it easier for consumers to engage with the market, and supply-side changes, which aim to incentivise firms to innovate and invest in response to customer needs.

4.4. We will consider the following structural reforms:

- **Smart metering:** the rollout of smart meters in Great Britain should open up new sources of flexibility and provide new ways in which consumers can engage

¹⁸ See Ofgem (2018), "[Default Tariff Cap: Policy Consultation](#)", pp. 43 – 47.

in the market. It may also facilitate innovation and the development of new business models. As part of our requirement to assess whether conditions are in place for effective competition, the Tariff Cap Act specifically requires Ofgem to consider the progress in installing smart meters for use by domestic customers;

- **CMA remedies:** in its Energy Market Investigation, the CMA proposed a series of changes to the regulatory framework to address some of the adverse effects on competition that it found to exist in the domestic retail energy market. As part of our framework, we propose to monitor the extent to which these remedies have been implemented. This will allow us to form a view on whether each remedy has met its intended objective.
- **Ofgem-led programmes:** our draft Forward Work Programme 2019-21 sets out our key priorities for delivering good outcomes for all consumers in the retail energy market, irrespective of whether or not they engage and make active decisions to change their supplier or tariff.¹⁹ This includes the implementation of programmes that should enable greater innovation in the energy market, such as electricity settlement reform and the faster, more reliable switching programme; and
- **Future Energy Retail Market Review:** we will consider additional changes to the market via this joint review. The review is intended to promote competition and to drive innovation by allowing innovative business models to capture system benefits, including flexibility in consumers' demand, while enabling all consumers to receive a good deal.²⁰

- 4.5. In addition to these ongoing government and regulator-led programmes, our assessment will review other market developments that could affect the demand- and supply-side of the market. For example, third party intermediaries can provide information and advice to consumers through the provision of a range of services, including switching websites, energy brokers and energy efficiency advice providers. Progress in these areas may be harder for us to measure as the relevant data are often not publicly available. However, it may be possible for us to assess, for instance, the use of price comparison websites through our consumer survey.²¹

Question 3: What are your views on the structural changes that we propose to include in our framework? Are there any specific changes you think we should consider?

- 4.6. We plan to monitor the response of process and outcome indicators to the structural changes (see Figure 2 below and Appendix 3).

¹⁹ Ofgem (2019), "[Forward Work Programme 2019 – 2021](#)".

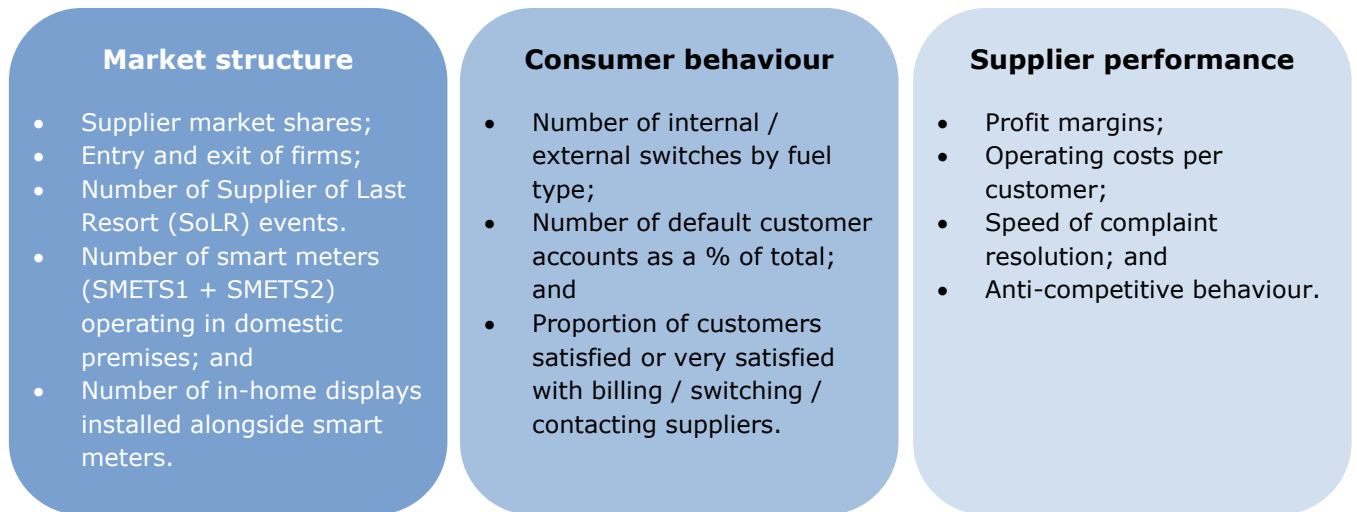
²⁰ Department for Business, Energy and Industrial Strategy (2019), "[Future Energy Retail Market Review: overview](#)".

²¹ See, for example, the findings of a survey we commissioned GfK (2018), "[Consumer Engagement in the Energy Market 2018](#)".

The process indicators we plan to monitor

4.7. We plan to monitor and assess a number of indicators to determine how well the competitive process is working. These fall into three broad categories: market structure indicators; measures of how consumers are responding to market developments; and indicators of suppliers' performance.

Figure 2: Examples of indicators of the competitive process



4.8. We do not intend to set specific targets or thresholds for each of the indicators. There are several reasons why we think that it would not be appropriate to set explicit targets in our framework:

- (i) there are different market and regulatory models that could deliver effective competition and these could be characterised by higher or lower levels for some of the indicators that we propose to include in our framework;
- (ii) indicators may be interdependent such that an increase in one leads to a decrease in another (or vice versa); and
- (iii) it is not clear whether an increasing rate for some indicators should always be interpreted as a positive outcome. For example, if switching rates are increasing this could reflect a greater level of engagement, but if they continue to increase it may be an indication of poor service quality that leads consumers to spend considerable effort in finding a reliable supplier.

4.9. One of the key lessons from previous removals of price controls – such as in the energy, telecommunications and postal sectors between 2002 and 2006 – is that the interpretation of indicators for market monitoring is complex and that the assessment

of individual indicators in isolation is not sufficient to assess whether a market is functioning effectively. An overall judgement is therefore required.²²

- 4.10. We appreciate that some of these indicators may be affected by the default tariff cap and we consider in the next section how best to account for these effects in our assessment.

Question 4: Are there any indicators of the competitive process not listed here that you think we should consider in our analysis?

How we will account for the impact of the default tariff cap

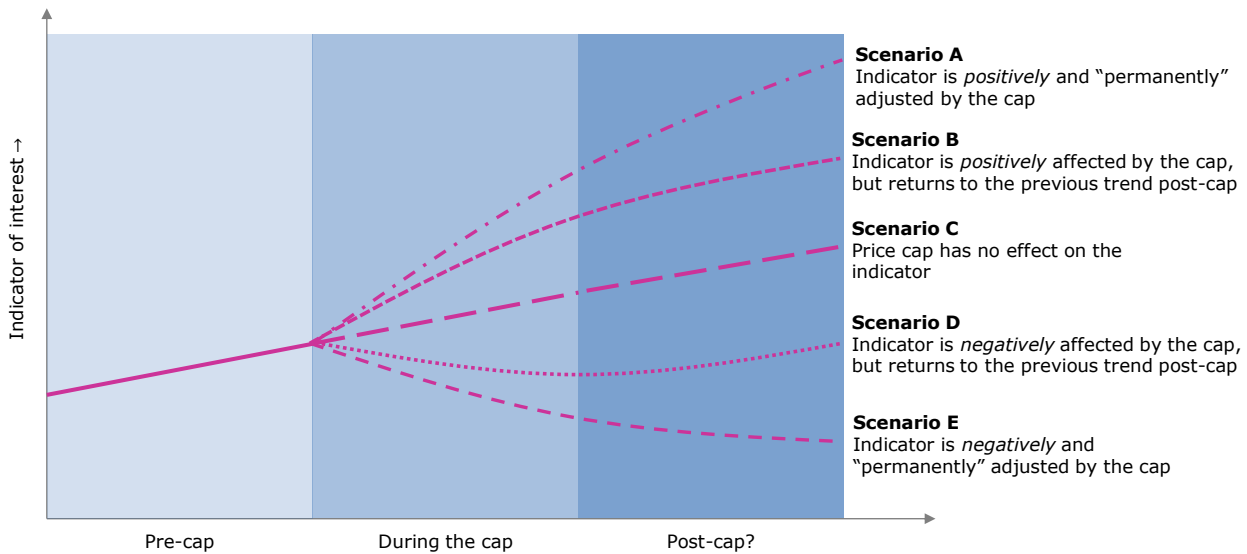
- 4.11. In our impact assessment of the default tariff cap, we undertook qualitative analysis that suggested that the default tariff cap could have an impact on competition and innovation in the retail energy market. For example, it could reduce the incentives for suppliers to compete and for customers to engage in the market.²³
- 4.12. We reviewed international case studies to understand the impact of price caps in energy markets. On the whole, it is difficult to predict what effects the default tariff cap will have on our process and outcome indicators as the impact of price caps tends to vary across different countries and energy markets. For example, there is evidence from Australia that a price cap reduced differences in tariff prices, switching rates and levels of innovation. However, the experience in Northern Ireland suggests that price caps have had a limited impact on switching rates and rivalry between firms.²⁴
- 4.13. We recognise that many of the indicators we are interested in could be affected in some way by the presence of the cap. It follows that we need to find a way of identifying the impact of the cap on these indicators and determining whether these effects would persist if the cap is lifted. Figure 3 below illustrates some potential (non-exhaustive) scenarios of how an indicator could be affected by the cap.

²² See NAO (2008), "[Protecting consumers? Removing retail price controls](#)", Report by the Comptroller and Auditor General.

²³ Ofgem (2018), "[Default Tariff Cap: Decision Final Impact Assessment](#)", pp 90 – 102.

²⁴ Ofgem (2018), "[Default Tariff Cap: Decision Final Impact Assessment](#)", pp 138 – 139.

Figure 3: Illustrative effects of the price cap on indicators



4.14. We are considering different analytical techniques that we could use to identify the effects of the price cap on the conditions for effective competition. These are discussed in more detail in Appendix 4.

How we will evaluate outcomes for consumers

4.15. The final part of our framework assesses whether competition is likely to generate good outcomes for most consumers, including those who do not switch or rarely switch suppliers:

- **Price and price differentials:** all else being equal, the price per unit of energy has a direct impact on consumer budgets. A lower price allows consumers either to spend more in other areas of their life or to save for the future (or some combination of the two).

We will also consider the extent of price differentials between the tariffs that engaged and less active consumers face;

- **Quality of service:** customers value suppliers that are responsive to their needs and are able to provide them with accurate information on their energy usage and billing in a timely fashion;
- **Tariff choice:** consumers differ in their preferences. For example, given the range of working patterns, lifestyles and time requirements, different households may benefit from different types of tariff, such as time-of-use tariffs;
- **Switching process:** the ease with which customers can change energy supplier directly affects their experience of the switching process and can encourage or discourage engagement with the market; and
- **Trust and confidence:** the interaction that consumers have with energy service providers, including suppliers and price comparison websites, can dramatically affect

their trust and understanding of how the energy market works and whether they are getting a good deal.

- 4.16. The relative importance of each of these drivers of consumer outcomes will likely vary across consumers in terms of income and engagement. However, the price per unit of energy could be a more important driver of outcomes for lower-income domestic consumers than for higher-income domestic consumers.
- 4.17. Since effective competition will not always deliver outcomes that meet the needs of consumers in vulnerable situations, provisions to complement effective competition may be required to ensure that they receive sufficient protection.
- 4.18. In view of Section 9 of the Tariff Cap Act, we intend to consider the circumstances in which effective competition cannot be expected to deliver outcomes that meet the needs of vulnerable consumers. However, determining the exact form of protection that would be required is not part of this framework. Instead, the Future Energy Retail Market Review with BEIS will consider how future market arrangements can provide protection from excessive price differentials for consumers in vulnerable circumstances.

Question 5: What are your views on the consumer outcomes that we propose to assess in determining whether the conditions are in place for effective competition?

Question 6: Is there any other aspect of effective competition that the framework should consider?

5. Next steps

In this chapter, we summarise the next steps for developing the framework before undertaking the first review in 2020.

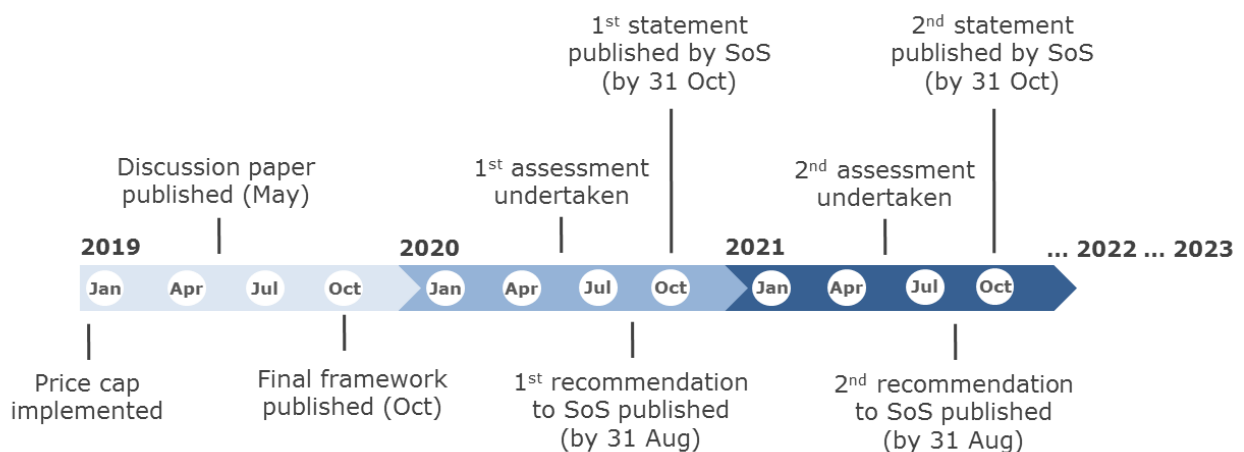
Engaging with stakeholders

- 5.1. In this discussion paper, we have set out our proposed framework for evaluating whether the conditions for effective competition are in place for domestic supply contracts. We plan to use the framework to support our recommendation to the Secretary of State on whether the default price cap should continue from 2021 or not.
- 5.2. We are seeking views from stakeholders on our framework over the next 6 weeks. We will consider responses in finalising the framework.

Key implementation milestones

- 5.3. After considering our recommendation, the Secretary of State will then publish a statement on or before 31 October 2020 that sets out whether the default tariff cap should remain in place.
- 5.4. Figure 4 illustrates the key milestones for undertaking the review on whether conditions are in place for effective competition for domestic supply contracts.
- 5.5. We will publish the final framework that we will use to undertake this assessment in the autumn of 2019. In accordance with the Tariff Cap Act, we will then publish our assessment on or before 31 August 2020 that includes a recommendation to the Secretary of State on whether the default tariff cap should be extended to have effect the following year.
- 5.6. After considering our recommendation, the Secretary of State will then publish a statement on or before 31 October 2020 that sets out whether the default tariff cap should remain in place.

Figure 4: Key milestones



6. Consultation responses and questions

- 6.1. We want to hear from anyone interested in this framework. Please send your response to EffectiveCompetition@ofgem.gov.uk.
- 6.2. We have asked for your feedback in each of the questions throughout this document. Please respond to each of these as fully as you can. For completeness, the full list of questions is as follows:
- **Question 1:** Are there any features of effective competition that are not covered in our definition?
 - **Question 2:** What are your views on the conditions for effective competition we have proposed? Are they clear and is there anything else you think we should take into account?
 - **Question 3:** What are your views on the structural changes that we propose to include in our framework? Are there any specific changes you think we should consider?
 - **Question 4:** Are there any indicators of the competitive process not listed here that you think we should consider in our analysis?
 - **Question 5:** What are your views on the consumer outcomes that we propose to assess in determining whether the conditions are in place for effective competition?
 - **Question 6:** Is there any other aspect of effective competition that the framework should consider?
- 6.3. Unless you mark your response as confidential, we may publish it on our website www.ofgem.gov.uk and maintain a copy in our library. You can ask us to keep your response confidential, and we will respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004. If you want us to keep your response confidential, you should clearly mark your response to that effect and include reasons. If the information you give in your response contains personal data under the Data Protection Act 1998, the Gas and Electricity Markets Authority will be the data controller. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. If you are including any confidential material in your response, please put it in an appendix to your response.

Appendices

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Appendix 1 – Privacy notice on consultations

Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller, (for ease of reference, “Ofgem”). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. i.e. a consultation.

3. With whom we will be sharing your personal data

We are not intending to share your personal data with other organisations. We are intending to publish non-confidential consultation responses, including any personal data that may be contained within them.

4. For how long we will keep your personal data, or criteria used to determine the retention period.

If you have provided your personal data, this will be held until six months after we have published the final framework for assessing whether conditions are in place for effective competition in domestic supply contracts. Publication of the final framework is scheduled for autumn 2019 but, in the event of unexpected delay, we will provide a revised publication date on our website. In any event publication of the final framework will be no later than 1 February 2020.

5. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at <https://ico.org.uk/>, or telephone 0303 123 1113.

6. Your personal data will not be sent overseas

7. Your personal data will not be used for any automated decision making.

8. Your personal data will be stored in a secure government IT system.

9. More information For more information on how Ofgem processes your data, click on the link to our "[Ofgem privacy promise](#)".

Appendix 2 – Uses of effective competition term in policy

Table 1: Examples of uses of the term effective competition in policy and regulation

Organisation	What they say about effective competition
<p><i>Competition and Markets Authority (CMA)</i></p>	<p>CMA response to government consultation: Modernising consumer markets green paper, July 2018</p> <ul style="list-style-type: none"> “effective competition – underpinned by the ability of consumers to compare and switch between suppliers – will usually lead to the best outcomes for consumers, but this is predicated on consumers, especially vulnerable consumers, being able to benefit from innovative and competitive markets in practice.” (para. 15) “effective competition creates the right environment for the development of new services and innovation” (para. 34) <p>Energy market investigation, June 2016</p> <ul style="list-style-type: none"> “If competition in retail energy markets is to serve customers’ interests, it is vital that the regulatory and technical framework allows suppliers to compete effectively. Provided customers are sufficiently engaged, this will drive down prices and improve quality of service” (para. 211)
<p><i>European Commission</i></p>	<p>Antitrust: Overview (http://ec.europa.eu/competition/antitrust/overview_en.html)</p> <ul style="list-style-type: none"> “Competition encourages companies to offer consumers goods and services at the most favourable terms. It encourages efficiency and innovation and reduces prices. To be effective, competition requires companies to act independently of each other, but subject to the competitive pressure exerted by the others.”
<p><i>Centre for Competition Policy (CCP)</i></p>	<p>BEIS Committee: Pre-legislative scrutiny of the draft Domestic Gas and Electricity (Tariff Cap) Bill inquiry: Consultation response from CCP”, 1 December 2017</p> <ul style="list-style-type: none"> “Competition is a (sometimes bumpy) process, and one of the advantages of markets, as compared with regulation, is they allow for evolution towards outcomes that were not previously envisaged. This means that what constitutes “effective competition” and what “conditions” are required for this to occur is inherently uncertain and may change through time.” “Moreover, the process of competition, even when considered effective, may generate outcomes that are unpopular with the public and do not meet with the expectations or desires of politicians or policymakers. For example, it is well understood that price discrimination can emerge even in highly competitive markets.” “Hence, we strongly caution against “effective competition” being viewed as necessarily involving all customers being charged the same low prices. It would be wrong to conclude from the presence of price discrimination that there is something automatically wrong with the functioning of the competitive process.”
<p><i>Financial Conduct Authority (FCA)</i></p>	<p>Promoting effective competition</p> <ul style="list-style-type: none"> “When competition works well, consumers are empowered as well as informed. They can make sense of the information they receive and can take their business elsewhere if they are not happy. In turn, firms strive to win custom on the basis of service, quality, price and innovation. This helps generate better outcomes for consumers. Markets are open to entry and innovation, and successful, innovative firms thrive, while unsuccessful firms change or exit.”

Appendix 3 – Process and outcome indicators in the framework

This Appendix sets out some of the process and outcome indicators that we are considering for use in the framework. This list is likely to evolve over time and it may be that some of these indicators do not feature in the final framework. Similarly, we may look to include further indicators that are not included in the below tables.

Table 2: Process indicators for evaluating the conditions for effective competition

Theme	Indicator	Frequency	Source
Market structure indicators			
<i>Innovation</i>	Number of initiatives going through Ofgem’s regulatory sandbox	Monthly	Ofgem
<i>Innovation</i>	Number of smart meters (SMETS1 + SMETS2) operating in domestic premises	Quarterly	BEIS
<i>Innovation</i>	Number of in-home displays installed alongside smart meters	Annual	Ofgem
<i>Rivalry</i>	Market shares: - Large energy suppliers (> 5%); - Small and medium suppliers (1-5%);	Quarterly	Ofgem
<i>Rivalry</i>	Market concentration	Quarterly	Ofgem
<i>Supplier entry / exit</i>	Entry and exit of firms	Quarterly	Ofgem
<i>Supplier entry / exit</i>	Number of Supplier of Last Resort (SoLR) events	Monthly	Ofgem
Consumer behaviour indicators			
<i>Engagement and switching</i>	Number of domestic customers switching by fuel type: - internal switching (with the same supplier) - external switching (between suppliers)	Quarterly	Ofgem
<i>Price and price differentials</i>	% of accounts by tariff type: - Large energy suppliers (> 5%); - Small and medium suppliers (< 5%);	Biannual	Ofgem
<i>Trust and confidence</i>	Proportion of customers satisfied or very satisfied with overall customer service	Quarterly	Ofgem

Theme	Indicator	Frequency	Source
<i>Trust and confidence</i>	Proportion of customers who find it very or fairly easy to contact supplier	Quarterly	Ofgem
<i>Trust and confidence</i>	Proportion of customers satisfied or very satisfied with billing	Quarterly	Ofgem
<i>Vulnerability</i>	Customers in debt / blocked switches	Annual	Ofgem
<i>Vulnerability</i>	Priority Service Register (PSR)	Annual	Ofgem
Supplier performance indicators			
<i>Efficiency</i>	Earnings before income & tax (EBIT) margins	Annual	Consolidated Segmental Statements
<i>Efficiency</i>	Operating costs - per customer - relative to price cap allowance	Annual	Consolidated Segmental Statements
<i>Trust and confidence</i>	Complaints resolved by the end of the next working day: - Large energy suppliers (> 5%); - Small and medium suppliers (< 5%);	Quarterly	Ofgem
<i>Trust and confidence</i>	Complaints resolved within 8 weeks: - Large energy suppliers (> 5%); - Small and medium suppliers (< 5%);	Quarterly	Ofgem

Table 3: Outcome indicators for evaluating the conditions for effective competition

Theme	Indicator	Frequency	Source
<i>Price and price differentials</i>	Average tariff prices (SVT vs fixed tariff): - Large energy suppliers (> 5%); - Small and medium suppliers (< 5%);	Monthly	Ofgem
<i>Quality of service</i>	Domestic energy supplier's customer service performance	Quarterly	Citizen's Advice
<i>Quality of service</i>	Energy survey results	Annual	Which?
<i>Quality of service</i>	Best energy service companies	Snapshot	Trustpilot
<i>Quality of service</i>	Satisfaction and trust (from survey data): - to charge a fair price - to provide clear and helpful information - to treat you fairly	Annual	Ofgem
<i>Tariff choice</i>	Number of tariffs offered in the market	Monthly	EnergyHelpline
<i>Switching process</i>	Average switching time for domestic customers	Quarterly	Ofgem
<i>Switching process</i>	Number of erroneous transfers	Quarterly	Ofgem
<i>Switching process</i>	Switching perceptions (from survey data): - length of time to complete process - complexity of process - risks to changing supplier - lack of time to engage	Annual	Ofgem
<i>Switching process</i>	Proportion of customers satisfied or very satisfied with ... switching process (among those who have ever switched supplier)	Quarterly	Ofgem
<i>Trust and confidence</i>	Consumer survey results of trust in suppliers and the market to provide high quality services at a fair price	Annual	Ofgem

Appendix 4 – Analytical techniques to identify the effects of the price cap

Testing for structural breaks

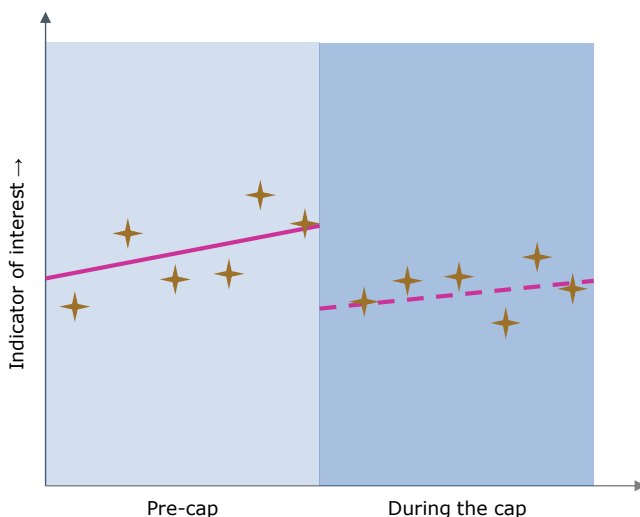
To isolate the effect (if any) of the price cap on a given indicator, we need to identify whether there is any significant change in the direction of travel of that indicator that can be attributed to the cap. We do this through searching for what is called, in statistical terms, a structural break.

A structural break arises when a time series abruptly changes at a point (or several points) in time. This can manifest as a change in the trend and/or level of the indicator. This may occur in response to a major event, such as the implementation of the default tariff cap.

We are proposing to use time-series econometric techniques to identify structural breaks in the indicators of interest. We would test for multiple breaks in the time series of each indicator to see whether key announcements and events in relation to the default tariff cap had any effect. For example, both the passage of the Tariff Cap Act in July 2018 and the implementation of the cap in January 2019 could have affected competition in the domestic retail energy market.

Figure 5 illustrates what a structural break in a time series might look like before (the solid line) and after (the dashed line) implementation. It shows a break that results in a different slope and intercept for the indicator of interest. This approach could be used to “net off” the impact of the price cap and identify the “direction of travel” of the indicator if the cap is lifted.

Figure 5: Illustrative presence of a structural break in the time series of an indicator



Considering a difference-in-differences approach

We are also considering alternative approaches, such as the use of difference-in-difference methods to examine whether the default tariff cap changed the trend of key indicators in the market for default energy tariffs relative to similar markets in Great Britain or elsewhere.