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Sent by email to: Maureen.Paul@Ofgem.gov.uk; EffectiveCompetition@Ofgem.gov.uk

Dear Maureen

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

Thank you for the opportunity to comment on Ofgem's proposed framework for carrying out the review of conditions for effective competition that is required by Section 7 of the Tariff Cap Act.

We have mixed views on Ofgem's proposed framework. We agree with Ofgem's proposed approach in a number of areas. For example, on Condition 2, we strongly agree with Ofgem that effective competition "is also characterised by efficient energy providers being able to finance their operations and make a reasonable profit"¹. Ability and incentives to invest are very important aspects of Condition 2, which emphasises prospects for competition *in absence of the cap*. Ofgem should monitor the impact of the cap itself on investment, a useful proxy for which is profitability. Logically, the more damage the cap inflicts on prospects for investment when it is in place, such as on smart meter rollout, systems and innovation, the more Condition 2 is met (because Condition 2 considers competition in absence of the cap). More generally, we believe that if the cap damages competition, then this should be considered by Ofgem and would add weight to a recommendation that the cap should be removed.

We agree that the review should take into account the impact of the cap itself on indicators, including smart meter rollout, and not set arbitrary thresholds to be achieved. We also have suggestions to build on Ofgem's framework, such as adding "realistic" as a guiding principle.

However, there are some issues with Ofgem's proposed framework. We summarise what we consider to be the most significant issues in this covering letter. We set out our detailed response in the Appendix.

¹ Ofgem consultation, paragraph 3.19
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- We are concerned that Ofgem is confusing *conditions* for effective competition with outcomes of competition. The Act refers explicitly to conditions. And as Ofgem has acknowledged, the cap itself may have a detrimental effect on competitive outcomes such as consumer engagement.
- Ofgem’s proposed Condition 3 (delivering good outcomes for most consumers, including those who are less active in the market) is not a condition for effective competition. As expert witness evidence cited in Ofgem’s own document² states, price differences are a common feature of highly competitive markets, and they drive competition by incentivising consumers to engage. Effective competition is good at delivering efficient outcomes, not delivering equally good outcomes for engaged and disengaged consumers alike. Neither does the evidence suggest that effective competition is “capable” of delivering equal outcomes.
- Ofgem’s draft Condition 3 more reflects that there are social and political concerns about unequal outcomes being consequences (and indeed drivers) of effective competition. However, the appropriate response to such concerns is not to redefine effective competition as delivering equal, or more equal, outcomes. The Tariff Cap Act itself separates conditions for effective competition (in Section 7) from concerns about tariff differentials and protection for vulnerable customers (in Section 9). Sections 7 and 9 of the Act, and their respective intents, should not be conflated. We discuss this further below.
- There is an inconsistency between a part of the definition of effective competition – “results in good outcomes for most consumers” - and language used to describe Condition 3 – “*capable* of delivering good outcomes for most consumers”³ (emphasis added). As we have said, the evidence suggests that neither phrase should be included in the definition of conditions for effective competition.
- Ofgem’s review of the academic literature and empirical practice is deficient. A much more thorough and up-to-date review is needed. Ofgem’s consultation references only four academic papers (one from 1940, one from 1958, and two from 2011), a 2008 paper from the NAO, and includes only a single page of quotations from the CMA, European Commission, CCP and FCA in Appendix 2. The reliance on two academic papers over fifty years old is particularly concerning, especially given the significant experience of competition and amount of work published since then.

Ofgem has said that “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”⁴. We agree with the implication of this statement, which is that the debate about potential protection for certain groups is separate from the review of conditions for effective competition. In other words, protection for certain groups of consumers is not an essential prerequisite to meet the test in Section 7 of the Act.

We look forward to engaging in discussions about potential future financial protections for certain groups of consumers, as and when any new proposals emerge. On financial assistance for vulnerable customers, our longstanding position is that:

² https://www.ofgem.gov.uk/system/files/docs/2019/05/cfec_discussion_paper_280519_finalversion.pdf
Appendix 2 page 30 – see quotations from the Centre for Competition Policy from its evidence to the BEIS Select Committee

³ Ofgem consultation document, page 6 final bullet point

⁴ Ibid, paragraph 3.22

- It would be most progressively funded via general taxation rather than energy bills.
- To the extent that it is provided by energy suppliers, it should be available from every supplier at the same level, and costs allocated equally across all suppliers (i.e. there should be no exemptions and there should be a reconciliation mechanism like with the Warm Home Discount).
- The target group of customers should be well-defined (e.g. ability to pay, or ability to engage) and assistance should be provided to those target groups consistently and objectively (e.g. if the problem is ability to pay, using DWP benefits data).

It is also important to understand and draw the distinction between consumers who are able to engage but choose not to, and those who are unable to engage. Different solutions may be needed for these different groups, and whether and the extent to which price differences are a problem should be considered in this context.

We hope that our comments are useful, and we look forward to continuing to engage with Ofgem in this process. In terms of process, we urge Ofgem to consult on its draft report produced under Section 7 of the Act before it is finalised and sent to the Secretary of State. We also note that, should the cap be extended beyond 2020, the Regulatory Policy Committee⁵ would expect to see a further Business Impact Target (BIT) assessment, supported by an Impact Assessment as necessary.

Yours sincerely

Alun Rees
Director, Retail Market Policy

⁵ https://www.ofgem.gov.uk/system/files/docs/2019/07/rpc-43581-beis_ofgem_domestic_gas_and_elctricity_default_tariff_cap_-_iaf_-_opinion.pdf
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Appendix – detailed response

Our key comments do not exactly match against Ofgem’s consultation questions, and the questions do not cover the entire consultation. Therefore, we have structured our response to reflect the order of Ofgem’s consultation under the following sections:

1. Principles guiding the framework
2. The definition of effective competition
3. The conditions for effective competition

1. Principles guiding the framework

- a. We agree with Ofgem’s three proposed principles for guiding the framework, which are for it to be transparent, evidence-based and practical.
- b. We recommend that Ofgem adds a fourth principle – realistic – or clarifies that practical covers realistic. The review should recognise that “perfect” competition does not exist, and consumers do not always behave as the textbook “rational” economic person. It might not be realistic to believe, for example, that all consumers are willing to engage regularly in the energy market.
- c. On the framework being evidence-based and realistic, we believe that Ofgem should capture indicators in other retail energy and consumer markets and compare them to this market. Such evidence should help understand how competitive the energy market is, and what is realistic. A relevant piece of evidence would be, for instance, the recent research from the Energy Switch Guarantee⁶ which found that 48% of those surveyed said they have switched energy supplier in the last four years. This was significantly higher than customers who said they had switched home insurance (35%), broadband (31%), telephone provider (24%) and bank (14%).
- d. On the “realistic” principle, we agree that Ofgem’s framework needs to account for the impact of the default tariff cap itself, including the potential for it to reduce incentives for suppliers to compete and for customers to engage in the market. Ofgem should be transparent in reporting such negative impacts to the Secretary of State, and depending on the severity, consider recommending that the cap - in the interests of current and future consumers - be removed.

2. The definition of effective competition

- a. For the purposes of this review, Ofgem has suggested that it would 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).*”⁷ Ofgem says that this proposed definition “*was informed by analytical frameworks [it has] used in the past, the academic literature, and the practice of other organisations*”⁸, and also reflects “*the specifics of the Tariff Cap Act and the parliamentary debate*”⁹.

⁶ <https://www.energyswitchguarantee.com/latest-news/nearly-half-of-energy-consumers-have-switched-according-to-new-survey/>

⁷ Ofgem consultation, paragraph 3.10

⁸ Ofgem consultation, paragraph 3.11

⁹ Ofgem consultation, paragraph 3.11

- b. It is not at all clear whether, and if so how, Ofgem’s proposed definition aligns with either (i) Ofgem’s own sources or (ii) the wider academic literature and empirical practice. There is no mention of effective competition resulting in “good outcomes for most consumers” in Appendix 2, and no cross references between this phrase and the other academic material Ofgem cites. Perhaps more worryingly, one of the sources in Appendix 2 (CCP) explicitly *warns against* use of a similar concept in the definition of effective competition:

“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.”¹⁰

- c. Similarly, it is not at all clear how Ofgem’s proposed definition reflects the specifics of the Tariff Cap Act and the parliamentary debate. As Ofgem acknowledges, the Tariff Cap Act does not define the conditions for effective competition, aside from requiring Ofgem to consider the progress of smart meter rollout. We are not aware of the definition of conditions for effective competition being discussed during the debates in Parliament, apart from the Minister confirming that it will be up to Ofgem to define.
- d. Based on Ofgem’s own source material, the “results in good outcomes for most consumers” element of the proposed definition looks neither (i) transparent - in how it has emerged - nor (ii) realistic - based on what the Centre for Competition Policy has said. As we have stated above, effective competition is good at delivering efficient outcomes, not delivering equally good outcomes for engaged and disengaged consumers. We therefore do not see how Ofgem can proceed with this part of the proposed definition.
- e. We also suggest that the definition should be amended to capture the dynamic nature of competition as a process of discovery, as reflected in the CMA’s guidelines for market investigations¹¹. The process of trying to “meet the existing and future needs of customers as effectively and efficiently as possible”¹² and “directing...resources to customers’ priorities”¹³ is necessarily one of test and learn (i.e. discovery). We therefore suggest that the definition is amended to: “effective competition is a rivalrous process of discovery between firms to win and retain customers”. In its proposed definition, we presume that Ofgem meant to use the term “vigorous” rather than “rigorous”, per the CMA’s guidelines¹⁴.
- f. Prior to reaching a decision on the framework, we believe that Ofgem should publish a more thorough and up-to-date review of the academic literature and empirical practice. On this matter, Ofgem’s consultation references only four academic papers (one from 1940, one from 1958, and two from 2011), a 2008 paper from the NAO, and includes a single page of quotations from the CMA, European Commission, CCP and FCA in Appendix 2. Having concluded a more thorough and up-to-date review of the literature, we would be surprised if Ofgem maintained that an “overarching” theme (which we interpret to mean consensus or majority view) is “the importance of developing a practicable set of conditions

¹⁰ Quotation from the Centre for Competition Policy from 1 December 2017, Appendix 2

¹¹https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/284390/cc3_revised.pdf See paragraphs 10-12

¹² Ibid, paragraph 10

¹³ Ibid, paragraph 12

¹⁴ Ibid, paragraph 12

for “directing” competition to *achieve socially desirable outcomes*”¹⁵ (emphasis added).

3. The conditions for effective competition

- a. We strongly agree with Condition 2, which “requires that the competitive process is expected to work well in the absence of the cap”. Given (i) the CMA’s emphasis on effective competition as a “process of rivalry”¹⁶, (ii) question marks about Condition 1 and (iii) inappropriateness of Condition 3, Condition 2 is the most important condition and should be given the most weight.
- b. Potential features of the “competitive process” Condition discussed by the CMA include:
 - i. “incentives for firms to meet the existing and future needs of customers as effectively and efficiently as possible—by cutting prices, increasing output, improving quality or variety, or introducing new and better products, often through innovation”¹⁷;
 - ii. “expansion by efficient firms and the entry into the market of new firms with innovative products, processes and business models, and the exit of less successful ones”¹⁸; and
 - iii. “Customers...stimulating rivalry between suppliers by making informed decisions which reward those firms that best satisfy their needs or preferences”.
- c. Features of Condition 2 may also include absence of threats or impediments to effective competition such as “significant market power”, “barriers to entry and expansion”, tacit coordination and “customers may lack information about what product to choose, may not be able to judge between different products on offer or may be locked into one supplier and unable to switch to another”¹⁹.
- d. On Condition 2, we strongly agree with Ofgem that effective competition “is also characterised by efficient energy providers being able to finance their operations and make a reasonable profit”²⁰. Ability and incentives to invest are very important aspects of Condition 2, which emphasises prospects for competition *in absence of the cap*. Ofgem should monitor the impact of the cap itself on investment, a useful proxy for which is profitability). Logically, the more damage the cap inflicts on prospects for investment when it is in place, such as on smart meter rollout, systems and innovation, the more Condition 2 is met (because Condition 2 considers competition in absence of the cap).
- e. On proposed Condition 1 – “structural changes are facilitating or can be expected to facilitate the competitive process” – we agree that Ofgem has to consider the progress of smart meter rollout since this is a requirement of the Tariff Cap Act. However, the impact of the cap itself on smart meter rollout would need to be taken account of as part of Ofgem’s review. To the extent that the cap itself damages conditions for effective competition, that should lend weight to a recommendation to remove it.

¹⁵ Ofgem consultation, paragraph 3.7

¹⁶ Ibid, paragraphs 10-12

¹⁷ Ibid, paragraph 10

¹⁸ Ibid, paragraph 10

¹⁹ Ibid, paragraphs 14 and 15

²⁰ Ibid, paragraph 3.19

- f. While structural changes may provide positive evidence that things have changed since the introduction of the default price cap, we do not consider that any of the structural changes mentioned are essential prerequisites for conditions for effective competition. Indeed, conditions for effective competition may be in place without any of the structural changes listed.
- g. Each structural change should be considered on its own merits. We urge Ofgem to avoid the risk that Condition 1 becomes a series of features that it would be “nice to have”, but that may not be feasible to achieve or that may be achievable only at disproportionate cost, or with unintended consequences that harm customers or competition.
- h. We consider that other structural features of the market that currently have a distortive effect on competition or inhibit conditions for effective competition may also be relevant. For example, it would be positive for effective competition if exemptions from policy costs were removed or thresholds lowered, or if smart meter rollout was better enabled by changing the opt-in framework. It would also be positive for effective competition if problems of moral hazard and adverse selection in the supply market that have contributed to multiple supplier exits were addressed by the introduction of new licence conditions.
- i. On proposed Condition 3, we have already discussed in the covering letter how is not a condition of effective competition. We have also discussed in section 2 above how the part of Ofgem’s proposed definition of effective competition that relates to Condition 3 is neither transparent nor realistic.
- j. We have already noted that price differences are a common feature of highly competitive markets, and they drive competition by incentivising consumers to engage. To the extent that the *reasons* for price differences are examined, Ofgem would need to assess, for example, whether and the extent to which price differences between tariffs are driven by factors such as differences in wholesale costs, exemptions from Government policy costs, differences in customer mix and whether prices allow for full cost recovery.
- k. Whatever the Conditions chosen, Ofgem should capture indicators for its Conditions in other retail energy and consumer markets, and compare them to this market. As stated in paragraph 1.c. above, such evidence should help understand how competitive the energy market is, and what is realistic. Obvious comparisons would include domestic energy in competitive markets not in GB, and other consumer markets in GB such as mobile phone contracts, broadband, insurance and banking. A key question to assess would be whether customers are on average more or less engaged in the present GB domestic energy market than they have been in the past, or in domestic retail energy markets in other countries, or in GB markets for other products and services. And if so to what extent is this attributable to the cap.