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Dear Maureen

We are writing in response to your consultation on the framework for assessing whether conditions are in place for effective competition in domestic supply contracts. This submission is entirely non-confidential and may be published on your website.

Citizens Advice is broadly comfortable with the approach proposed of conducting a rounded assessment that considers a range of different market indicators and consumer outcomes in order to reach an overall view of whether conditions would allow for the cap to be lifted, rather than setting a prescriptive and rigid list of pass/fail criteria. It is imperfect, and the degree of ambiguity and subjectivity it allows for may mean that stakeholders are uncertain on how it will operate in practice, or lack confidence that they can predict the outcome of the annual assessment it drives. But we think it is likely to be the least worst approach on the table when dealing with such a complex problem. Adopting a stricter approach of a series of defined pass/fail tests would present even greater problems as there is no inarguable science that could be applied to establishing what those tests are, the thresholds that would be set for them, or how they should be weighted in regard to each other. Many relevant factors could not easily be measured or parameterised. So some element of human judgement in reaching the overall recommendation appears inevitable and prudent.

We also note that while discussions with stakeholders suggest some uncertainty on how the proposed framework will be applied, that this largely relates to its first year of operation. From year two, assuming the cap is extended, the previous year(s) assessments should provide significant precedent allowing stakeholders to understand how it will be applied, and a sense of the implicit weightings or expectations being given to its components. Notwithstanding this, it does leave a year one issue that stakeholders may not have a strong sense or understanding of how the assessment will work, with knock on effects on their ability to plan. We encourage you to consider if there are ways in which you could mitigate or reduce that uncertainty. You may wish to consider whether some form of 'dry run' is possible before the first formal assessment, although we recognise that this could have significant resource implications.

The three broad conditions you propose to use in your assessment are relatively comprehensive in their scope, but appear potentially clumsy in their application.

The structural changes condition covers a wide range of policy initiatives, at various stages of conception and implementation, including some that are very much still on the drawing board (most notably in wishing to take account of the outcomes of the Future Retail Market Review, which is yet to reach firm proposals). While relevant, predicting the effectiveness of many of the measures within the scope of this condition will take Ofgem into highly speculative territory, with some risks of optimism or confirmation bias given that it will be in some cases assessing its own policies. Ofgem's assessment will need to be clear on how confident it is that these policy interventions will work, the limits of that confidence, and any distributional impact it envisages that they may have. The weighting given to individual interventions will need to reflect the level of uncertainty in their outcome.

The competitive process condition appears to assume that if barriers to entry, exit and action are low, and that if the information provided to consumers is good, then competition and engagement will naturally follow. While useful indicators, we feel obligated to note that this theory of engagement has been tested in the energy sector in the past and has failed. The retail energy market has had low barriers to entry and exit for some considerable time, the vast majority of consumers have been aware of their right to switch right back to the point of market opening, and barriers to switching are usually low. Yet despite those conditions, it has been a market characterised by majority disengagement, with the disengaged suffering a significant loyalty penalty, and with consumers as a whole paying a significant price in terms of excess profits and inefficiency. Taken in isolation, the competitive process condition appears unlikely to prove a good barometer of whether the majority of consumers will experience good outcomes from the market. More broadly, we would caution against excessive reliance on theory when judging whether the conditions are in place to allow for a removal on caps, as much of the mainstream theory in this area has not withstood practical application in the period since liberalisation. A similar theoretical basis was applied to the previous removal of price caps, which resulted in the two-tier market that this price cap is trying to cure. We also note that the near-consensus expert opinion prior to the introduction of this cap was that it would reduce switching rates and price spreads. There is currently no evidence that it is doing either of those things, although we recognise the whole market price cap is relatively new.

Because of these weaknesses in the first two conditions Citizens Advice see the third condition, relating to consumer outcomes, as crucial. Ultimately the litmus test for both the cap itself, and for the long term health of the market after it has gone, is whether most consumers receive good outcomes on the things they care about: on price; on quality of service; and in having a choice of products that meet their needs and preferences. It is these consumer outcomes that will dictate whether they are well served by the market. We therefore put the strongest weighting on this condition. While noting your intention to consider progress against the conditions in the round, we suggest that the cap should only be lifted if a positive assessment can be made against this condition, regardless of whatever progress has been made against the other two. We think that Ofgem also needs to be able to demonstrate that it, and its stakeholders, can have a high degree of confidence that the loyalty penalty paid by disengaged consumers will not simply re-emerge when it lifts the cap, before it lifts it. If it cannot, the cap should remain in place.

We do not under-estimate how hard this assessment process will be for Ofgem. In many areas it will be seeking to predict the future - whether in terms of the impact of ongoing policy initiatives and structural changes to the market, or in terms of how the market might evolve once the cap is lifted. This will involve a significant level of subjectivity and imprecision. It is therefore unlikely that it will be able to find a framework that pleases all (or possibly any), and that can rise above dispute. So while we have reservations about aspects of the proposed framework, we also recognise that it is a balanced approach to a difficult task.

In the remainder of this submission we provide responses to the specific questions raised in your consultation.

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

We think it is a reasonable 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?

We think the conditions are reasonable if considered as part of a rounded assessment, although several are problematic if considered in isolation.

The first of the three conditions, relating to whether structural changes are facilitating or can be expected to facilitate the competitive process, has two core characteristics that will make it difficult to apply: its speculative nature; and the risk of optimism or confirmation bias.

The structural changes you identify include ongoing ones, such as smart meter rollout, the emergence of automatic switching services and the implementation of remedies required by the 2014-16 CMA investigation, and reforms that are yet to be implemented, such as quicker switching and the outputs of the Future Retail Market Review (FRMR). In some cases, particularly in relation to the FRMR, it is far from clear at this time what structural changes may come forward, let alone to what timetable.

The application of this condition is therefore likely to involve significant speculation on Ofgem's part, as it will have to judge the likely impact of interventions or changes that have yet to occur, or in some cases even to be defined. In suggesting that future policy changes that may not be in place by the time of Ofgem's first assessment in August 2020 are relevant to its recommendation of whether the cap can be lifted, you should be mindful that this may be interpreted by the market as a strong signal that the cap cannot be lifted in 2020.

Further, because many of the structural changes identified relate to policy interventions that Ofgem has either led, or been heavily involved in, there is a knock on risk of optimism or confirmation bias in its assessment. By definition, Ofgem will only implement proposals that it considers are consistent with its statutory duties. It would therefore appear unlikely that, when separately assessing them for the purposes of considering whether the cap should be retained, it would conclude that they will not work. You should therefore be mindful that Ofgem may be perceived to be 'marking its own homework' in relation to this condition, and we would encourage you to consider if there are steps you can take to reduce that perception.

Ofgem's assessment will need to be clear on how confident it is that these policy interventions will work, the limits of that confidence, and any distributional impact it envisages that they may have. The weighting given to individual interventions will need to reflect the level of uncertainty in their outcome.

While the package of proposals that may come forward as a result of FRMR is highly unclear at this stage, it may become clearer by the time of your first assessment. We therefore encourage you to seek to clarify which components of that package are relevant to your assessment as that detail emerges.

The second of the three conditions, that the competitive process is expected to work well in the absence of the cap, is the most straightforward to apply but may result in falsely optimistic picture of the readiness of the market for the removal of caps.

The second condition applies some fairly standard classical measures of competitiveness to the market, such as whether barriers to entry and exit and switching are low, and whether consumers have good information on their options. While not without use, we consider these measures somewhat ignore the circumstances that resulted in the introduction of the cap. Strong arguments can be made that, in a pre cap world, the barriers to entry and exit were already very low (arguably too low, given some of the financial sustainability and operational performance problems experienced by some new suppliers and suffered by their customers), that most consumers received good information, and that barriers to switching were usually low. But despite those characteristics, most consumers were disengaged from the market and experiencing bad price outcomes. It therefore does not appear that these metrics listed under this condition are well aligned with positive consumer outcomes - these tests may lack relevance, and may present a false view of the likelihood of future consumer engagement.

In our view, the third condition, that consumers is expected to deliver good outcomes for most consumers, including those who are less active in the market, is the most important of the three. This is because it is the least grounded in theory and most grounded in actual consumer experience.

Ultimately, the test for whether the cap should be lifted is whether most consumers would be likely to experience outcomes that are both good in their own right, and that are at least as good as those they would have received had the cap been retained.

Ofgem notes that it is separately required to consider whether there are categories of domestic consumers that require protection against excessive charges, and our understanding from the workshop session on 24 June is that it intends to take forward that review as a separate exercise. We note that there is an interaction between the two reviews, in that in order for Ofgem to make an assessment on whether competition will deliver good outcomes for most consumers under the third condition, it would appear necessary to know which consumers are separately protected. Before making any recommendation to remove the broader cap we would expect to see Ofgem bottoming out and being ready to implement any narrower protection needed for vulnerable consumers, in order to avoid any gaps in protection.

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?

As noted in our answer to Question 2, we think the structural changes condition will be hard to apply in practice given its often speculative nature and the risk of optimism or confirmation bias when it is applied to policy choices. We would therefore encourage you to firm up and, if possible, reduce the number of variables or programmes that you consider relevant to your assessment. For example, in relation to the CMA remedies it may be useful if you can be more specific about whether you consider all to be relevant to your assessment, or whether only a subset are.

For those policy programmes where implementation has yet to start, or is ongoing, it would be useful if you can set out your expectations on when you think sufficient progress will have been made that a decision on the success or not of that intervention can be reached.

In relation to smart metering, while the Tariff Cap Act simply requires Ofgem to consider the progress that has been made in installing smart meters as part of its assessment - on face value, simply to assess whether smart meter rollout is on schedule or not - we encourage you to additionally look at whether smart metering has impacted, positively or negatively, on consumer engagement or outcomes, and, if so, what the distributional impact of that effect has been.

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

We are broadly supportive of the list of indicators set out in figure 2.

Noting that the CMA's conclusion was that the £1.4bn/year consumers were paying in excess of what it would expect under a well functioning market was split roughly half and half between excess profits and inefficiency, we would expect you to have indicators allowing you to assess the erosion of both. We think this is likely to be possible under the profit margin and operating costs indicators, but it may be useful if you can be more explicit about what you are seeking to measure in those areas - of what success or failure looks like.

While you have several quality of service measures among your indicators, we would encourage you to broaden them to include Citizens Advice's star rating tool. We have found this an effective and insightful tool to understand the operational performance of suppliers, and it has the benefit of being widely understood and credible within the supplier community.

On the specific measure of 'anti-competitive behaviour' it may be useful if you can set out clearer expectations of what you are seeking to measure. Would this be measured through the volume of enforcement cases, through the value of those cases, or something different?

While the indicators you highlight are still useful at aggregate level, they will be more useful still if you can break them down for different categories of consumers. So, for example, in looking to understand why consumers do not switch it may be useful to understand if the nature of deals in the market favours certain types of customer - for example, those who are online, who have bank accounts, who can lodge significant upfront credit, or who are likely to pass credit checks etc. We will look to you for evidence that the market serves different types of consumers well, and not simply that it serves the majority well. You may find it useful to break down your assessment by a number of customer archetypes in order to be comfortable that the market is serving all types of consumers, and not simply some.

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?

We think the range of outcomes you identify are broadly the right ones, though we would caution against over-relying on the insight that can be gained from price differentials.

In theory, price differentials should give an indication of the strength of incentive on consumers to engage. But in practice, the historical correlation between price spreads and switching rates in the GB electricity and gas retail markets has been poor.[1] In addition, as a metric it is unclear what success looks like. Are high price spreads a good thing, because they signal very strong incentives to engage? Or are they a bad thing, because they signal how badly disengaged consumers are ripped off? Price differentials will also be affected by policy cost exemptions for small suppliers and by the differing demographic breakdown of what types of customers different suppliers serve.

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

Not at this time, we think the range of areas you identify are broadly the right ones.

I trust that this response is clear, but would be happy to discuss any matter raised within it in more depth if that would be helpful.

[1] See our response to your third working paper on the introduction of the price cap, 13 April 2018. https://tinyurl.com/y5293yjz

Yours sincerely

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