

Decision

Decision – Framework for assessing whether conditions are in place for effective competition in domestic supply contracts

Publication date: 3 October 2019

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This decision document sets out the framework that we will use to assess whether conditions are in place for effective competition in domestic supply contracts. It takes into account responses to the consultation we carried out on our proposed framework from 29 May to 9 July 2019.

The requirement for us to undertake a review into whether conditions are in place for effective competition in domestic supply contracts is set out in Section 7 of the Domestic Gas and Electricity (Tariff Cap) Act 2018. The first review must be published by 31 August 2020, and should include a recommendation on whether the cap on default tariffs 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 and, if needed, for a final time in 2022. The cap will cease to have effect at the end of 2023, at the latest.

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Foreword

Energy is an essential service and the lifeblood of our economy. As the independent energy regulator for Great Britain, we make decisions that aim to ensure the energy market is working in the interests of consumers and that they are paying a fair price for their energy.

In July 2018, the Domestic Gas and Electricity (Tariff Cap) Act came into force. This legislation required the Authority to design and implement a temporary cap on standard variable tariffs and default tariffs. This price cap came into effect in January 2019. The legislation also requires us to assess, from 2020, whether the market has moved on in the right directions such that the conditions are in place for effective competition, and to recommend to the Secretary of State whether or not the price cap should be lifted. This is the purpose of the framework in this paper.

In the summer, we asked stakeholders for their views through a consultation document and a workshop. Stakeholders welcomed our transparent approach and were generally supportive of our framework, requesting more detail on some aspects. We carefully considered the comments we received and are now publishing the final framework that we will use to assess whether conditions are in place for effective competition and to support our recommendation next summer.

Our framework defines what we mean by effective competition in the domestic retail market, demonstrating clearly that we cannot return to the pre-price cap world where groups of consumers were unjustifiably paying more than they needed to for their energy. While the final decision about whether or not the price cap should be lifted will be a matter for the Secretary of State, our recommendation will be wholly independent and purely based on evidence and rigorous analysis.

We will continue to hold suppliers to account, making sure consumers are protected, especially the vulnerable, stamping out sharp practice and ensuring fair treatment. At the same time, we are working to ensure that we have an energy market where competition and innovation can thrive, driving down prices and providing new products and services to consumers.

The processes of digitalisation and decarbonisation are radically changing business models and creating innovative ways for consumers to interact with their energy providers. This is also creating challenges for suppliers who are not able to adapt and consumers who are not able to access or take advantage of new technologies. As the retail energy sector continues

to transform and change in ways that are very different to how the market worked in the past, it makes it even more important that we keep pace with these developments and ensure that consumers are not left behind.

We cannot predict whether the price cap will be lifted before the end of 2023, but consumers can be sure that we will take every possible step to ensure that we do not return to the pre-cap world where consumers were penalised for their inactivity or loyalty. It may take time for competition to become effective and we will not recommend lifting the cap until, in our independent judgement, we are confident that the market is capable of delivering fair outcomes for consumers and that we have identified protections that can be implemented in a timely manner for those who, for whatever reason, do not engage in the market.

Dermot Nolan, Chief executive officer, Ofgem



Executive summary

The Domestic Gas and Electricity (Tariff Cap) Act 2018 (henceforth, 'the Tariff Cap Act') requires us to assess whether conditions are in place for effective competition in domestic supply contracts. This assessment will be used to make a recommendation to the Secretary of State on whether or not the price cap on default tariffs should be lifted before the end of 2023, when it finally expires.

We are grateful for stakeholders' views on our proposed framework for carrying out this assessment, which we sought through the consultation document published in May and a stakeholder workshop in June. This document presents our finalised framework for assessing whether conditions are in place for effective competition in the supply of domestic contracts.

Our framework is guided by the three principles of being transparent, evidence-based, and practical. It is made up of three core elements, which set out how we define effective competition, the resulting conditions that would need to be in place for there to be effective competition, and how we will assess whether these conditions are met.

How we define effective competition

The Tariff Cap Act does not define effective competition, and there is no clear definition to draw on from academic and policy literature. For the purpose of our assessment, we have defined effective competition as set out in Figure 1.

Our definition is concerned with both the functioning of the competitive process and the outcomes that this process and the market, as a whole, generate for consumers in terms of what matters to them (eg price, quality of service, range of tariffs, clear information). While consumers will benefit from competition to differing degrees, we expect effective competition in the energy market to deliver fair outcomes for consumers. This includes not being overcharged, receiving a good quality of service, and having access to a range of energy products and services.

Figure 1: Effective competition - definition and conditions

We consider competition to be effective if ...

There are no significant barriers to consumers being able to access, assess and act on information about the products and services they may want, driving rivalry between firms to win and retain customers.

Consumers get fair outcomes in terms of what matters to them, including:

- Not being overcharged by firms making excessive profits or passing through inefficient costs.
- Having access to a reasonable range of tariffs to meet different needs.
- Receiving a good quality of service.

The conditions that would need to be in place for effective competition are...



The conditions required for effective competition

Our framework sets out three conditions that would need to be in place for there to be effective competition in domestic supply contracts:

1. Structural changes

Structural changes are facilitating or can be expected to facilitate the competitive process. These structural changes include those from the government, Ofgem, and the wider market. Within this wide group of structural changes, we are explicitly required by the Tariff Cap Act to consider the progress of the supplier-led roll-out of smart meters for domestic consumers. The changes that we are implementing include, for example, our Supplier Licensing Review, as well as some of the recommendations from the Competition and Market Authority’s Energy Market Investigation in 2016.

2. Well-functioning competitive process

The competitive process in the domestic retail energy market should be expected to work well in the absence of the cap. For example:

- There should be no significant barriers to consumers being able to access, assess and act on information on product offerings in the market.
- There should be sufficient commercial opportunity for any well-prepared prospective supplier to enter the market.
- There should exist strong rivalry across market providers to meet the needs of consumers, with a level playing field (eg, no material concerns of anticompetitive behaviour).

3. Fair outcomes for consumers

The competitive process should be expected to deliver fair outcomes for consumers in terms of what matters to them, including prices, range of tariffs to suit needs, good quality of service, and ease and reliability in switching products. For example, consumers should not be overcharged for their energy use, either due to excessively high prices or inefficient costs.

Assessing whether the conditions for effective competition are in place

Our assessment will monitor the direction of travel of a range of indicators in the competitive process and the outcomes for consumers. We will not set specific thresholds on any individual indicator and we will consider all indicators in the round to form an overall view of how both the competitive process and consumer outcomes can be expected to evolve were the price cap to be lifted. Table 1 sets out examples of indicators we may use in our assessment.

Table 1: Assessment of the conditions for effective competition

Indicator type	Examples of possible indicators	Overall view of direction of travel
Competitive process	<i>Market structure:</i> -Market shares. -Entry & exit rates.	Taking all relevant indicators into account, we will make an overall
	<i>Consumer behaviour:</i> -Overall engagement.	

	-Consumer understanding of product offerings in the market.	assessment of how both the competitive process and consumer outcomes may evolve in the absence of the cap.
	<i>Supplier performance:</i> -Supplier costs. -Efficiency costs.	
Consumer outcomes	<i>Price, price differentials, quality of service</i>	

Although we have developed our framework to meet our requirements under Section 7 of the Tariff Cap Act, we expect it to contribute to wider discussions on how to define and assess effective competition.

1. Introduction

Chapter summary

In this chapter, we set out the following:

- The background and context in which this framework has been developed.
- The requirement on Ofgem, as set out in The Domestic Gas and Electricity (Tariff Cap) Act 2018 (henceforth the Tariff Cap Act), to assess whether conditions are in place for effective competition for domestic supply contracts.
- A high-level overview of how we have taken into account stakeholder responses to our consultation on the proposed framework.
- The structure of the rest of this paper.

Background and context

1.1. In recent years, the domestic retail energy market was not working as well as it should have for all consumers. Consumers who were actively engaged in the market and shopped around could usually find a good deal, but those who were less active and on default tariffs would pay substantially more. This overcharging was likely driven by two forces: prices for default tariffs not moving in line with the costs suppliers face; and/or suppliers operating inefficiently and passing on these inefficient costs to consumers.¹ The government and Ofgem were concerned about this “two-tier” market and took action to remedy the resulting poor outcomes for consumers, including putting in place:

- ***A range of structural reforms designed to improve the functioning of the retail energy market.*** These include reforms from the government, such as the supplier-led roll-out of smart meters, and reforms from Ofgem. Our reforms include, but are not limited to, the Supplier Licensing Review and some of the recommendations from the CMA’s Energy Market Investigation in 2016.² We

¹ For example, see Competition and Markets Authority (2016) “[Energy Market Investigation: Final report](#)”

² The CMA concluded that the domestic energy market was not working well for all consumers and identified adverse effects on competition, such as weak customer response and price discrimination.

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.³

- **A temporary cap on standard variable and default tariffs.** This cap was introduced through the Tariff Cap Act and implemented 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 close to £1.1 billion per annum.⁴ 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, as required under the Tariff Cap Act (and discussed below).

Our requirement to review conditions for effective competition

- 1.2. While reforms to improve the functioning of the retail energy market are implemented, the default tariff cap will protect consumers from being overcharged for their energy. Before the Secretary of State decides whether to remove the price cap, Section 7 of the Tariff Cap Act requires that Ofgem assesses whether conditions are in place for effective competition in the domestic supply market. On the basis of our findings, we will make a recommendation to the Secretary of State on whether or not the cap should be extended.
- 1.3. The key requirements and timelines for producing the review are the following⁵:
 - (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 –

It identified a range of remedies to help address these issues. See CMA (2016), "[Energy market investigation: Final report](#)".

³ See our joint consultation with the Department for Business, Energy and Industrial Strategy on '[Flexible and responsive energy retail markets](#)'.

⁴ Ofgem (2018), "[Decision – Default tariff cap – Overview document](#)", p. 6.

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

- (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. Following the consultation on our proposed framework between 29 May and 9 July, this decision paper provides a detailed overview of our final framework.⁶

How we have taken stakeholder consultation responses into account

1.5. In our consultation, we asked stakeholders for their views on each of the key components of our framework, including: how we define effective competition and the conditions that give rise to it; the structural changes that will help improve the functioning of the competitive process; and the indicators that we will use for our assessment. For each of these areas, we discuss the key themes from stakeholder

⁶See Ofgem (2019) "Discussion paper: [Developing a framework for assessing whether conditions are in place for effective competition in domestic supply contracts](#)"

responses and explain how we have incorporated them, where appropriate, into the development of our final framework.

1.6. The key themes we identified from the responses are:

- **Definition of effective competition:** There was general agreement on our proposed definition of effective competition, however clarification was requested on how we interpret specific terms and on what competition should be expected to achieve.
- **Structural changes:** There were requests for more detail on the structural changes that we will monitor and how we will measure their impact on the functioning of the competitive process and, in turn, consumer outcomes.
- **Consumer outcomes:** Although there was general agreement on the consumer outcomes we proposed, stakeholders requested further clarification on how we will look at issues such as price differentials, in particular ensuring that differences in costs are taken into account where appropriate.

Structure of this decision paper

1.7. The remainder of this decision paper is structured as follows:

- In Chapter 2, we provide a high-level overview of the framework we have developed for assessing whether conditions are in place for effective competition in domestic supply contracts. We also discuss the principles that guide our framework.
- In Chapter 3, we set out our definition of effective competition and, in turn, the conditions that should be in place to meet our definition. The conditions focus on how the competitive market process should function to deliver good outcomes for consumers. Following our consultation, we have been more explicit in explaining what we mean by good outcomes, which is about consumers getting a fair deal. How we measure the competitive process and consumer outcomes is discussed in Chapters 4 and 5.
- In Chapter 4, we discuss our approach to assessing key indicators of the competitive process, including market structure, supplier performance and measures of consumer engagement.
- In Chapter 5, we discuss our approach to assessing key indicators of consumer outcomes, including price and price differentials, quality of service, tariff choice,

the ease and reliability of the switching process and overall consumer trust and confidence.

- Finally, we discuss next steps in Chapter 6.

2. An overview of our framework

Chapter summary

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

- 2.1. We have used responses to our consultation to develop and refine the framework that we will use to meet our requirement to assess whether conditions are in place for effective competition in domestic supply contracts. We expect the framework to evolve over time to take account of developments in the market and / or lessons learned from our assessment(s).

Principles guiding the assessment framework

- 2.2. Our framework is guided by three key principles:
- **Transparent:** the methodology and decision-making process will be clearly communicated to stakeholders so that they can understand the reasons for any recommendation we make on lifting or not lifting the price cap.
 - **Evidence-based:** the analytical framework will be underpinned by quantitative and qualitative data on the indicators and structural changes that we expect to monitor and assess.
 - **Practical:** the decision-making process will be practical, allowing us to use our knowledge and expertise to make an overall independent 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, and we will take a realistic view on what competition can be expected to achieve.

Overview of the assessment framework

- 2.3. We summarise the framework in Figure 2. It defines what we mean by effective competition and specifies the conditions that need to be in place for there to be effective competition in domestic supply contracts. It also highlights some of the main indicators we will assess to determine how well the domestic energy market is

working and the outcomes that it generates for consumers. We have developed our framework to meet our requirements under Section 7 of the Tariff Cap Act, but we expect it to contribute to wider discussions on how to define and assess effective competition.

2.4. The framework has been informed by:

- The Tariff Cap Act and Parliamentary discussion about the Bill.
- Academic and policy literature on the characteristics of competitive markets and the outcomes they should generate for consumers.
- Recent practice in the regulatory and policy spheres, including the CMA's consultation response to the government's Modernising Consumer Markets Green Paper and Ofcom's ongoing work on fair outcomes for consumers.⁷
- Stakeholders' views, which were gathered at a workshop and through the consultation on our proposed framework.⁸

⁷ CMA (2018), "[Modernising consumer markets green paper: CMA response to Government consultation](#)".

Ofcom (2019) "[Making communications markets work well for customers: A framework for assessing fairness in broadband, mobile, home phone and pay-TV](#)".

⁸ Ofgem (2019) "Discussion paper: [Developing a framework for assessing whether conditions are in place for effective competition in domestic supply contracts](#)".

Figure 2: Framework for assessing whether conditions are in place for effective competition

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 of 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, being realistic on what competition can achieve. We will not set specific thresholds, which could prove misleading.

1

Effective Competition in the context of this review

We will consider competition to be effective if there are no significant barriers to consumers being able to access, assess and act on information about the products and services they may want, driving rivalry between firms to win and retain customers. Consumers should get fair outcomes in terms of what matters to them, including not being overcharged from either firms making excessive profits or passing on inefficient costs, having access to a reasonable range of tariffs to meet different needs, receiving a good quality of service and being able to transfer quickly and reliably.

2

The Conditions for Effective Competition

The conditions are considered jointly and may be met individually to varying degrees. The specific considerations in the conditions may be updated over time with market developments.

Structural changes

Structural changes in the market are facilitating or are expected to facilitate the competitive process. These changes include:

- Reforms promoted by the government (eg smart meters) and Ofgem (eg Supplier Licensing Review)
- 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 material concerns about anti-competitive behaviour nor unnecessary barriers to consumers and energy service providers participating in the market. Consumers must be able to choose confidently and well, and there must be sufficient commercial opportunity in the market to attract entry, innovation and investment.

Fair outcomes

The competitive process should be expected to deliver fair outcomes for consumers in terms of what matters to them, eg, prices, quality of service, information, tariff choices and the ease and reliability of the switching process.

Support and protection for some customers - including those in vulnerable situations - may be required.

3

Process and outcome indicators

Process indicators (examples)

- *Market structure:* market shares, entry and exit of suppliers
- *Consumer behaviour:* engagement, switching, consumer understanding
- *Supplier performance:* costs, efficiency

Outcome indicators (examples)

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

3. Our definition and conditions for effective competition

Chapter summary

In this chapter, we set out:

- What we mean by effective competition for the purpose of this framework.
- The conditions we consider must be in place for effective competition to develop in domestic supply contracts.
- The key stakeholder responses we received on our definition and conditions in our consultation.

3.1. The Tariff Cap Act does not define effective competition, and there is no generally accepted definition in relevant policy frameworks or academic literature. We have developed a definition for the purpose of setting a framework to meet our requirements under Section 7 of the Tariff Cap Act. We believe it is important to be clear about the standard our framework and, therefore assessment, is set against.

3.2. Our definition and related conditions should be viewed within the context of the requirements under the Tariff Cap Act (ie, to assess whether conditions are in place for effective competition in domestic supply contracts, and make a recommendation on whether the price cap on default tariffs should remain in place or be lifted). Our framework takes into account the specifics of the Tariff Cap Act and the parliamentary debate on the Tariff Cap Bill.

3.3. We have drawn on the experience of previous price controls that were lifted, such as our removal of retail price controls in 2002 in the energy sector and in the telecommunications and postal sectors between 2002 and 2006.⁹

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

Literature on effective competition

- 3.4. Despite the widespread use of the term ‘effective competition’ by policymakers, competition authorities and regulators, there is no consistently applied definition of it.¹⁰ In broad terms, there is agreement that effective competition involves strong rivalry that prevents firms from exercising market power. However, specific definitions differ across assessments, depending on factors such as market features and consumer and societal concerns.
- 3.5. 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 what is achievable in practice when market “imperfections” are accounted for, such as barriers to the entry and exit of firms and partially informed consumers.¹¹ While this work sparked debate, a clear consensus or generally agreed definition has not followed.
- 3.6. An overarching theme in the literature is the importance of developing a practical 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. Moreover, a definition of effective competition should 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
- 3.7. Appendix 1 provides some examples of how the term “effective competition” is used by other organisations, such as the Competition and Markets Authority (CMA) and the Financial Conduct Authority (FCA). The rest of this chapter sets out our definition

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.

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.

of effective competition and the conditions that must be in place to achieve it. We also discuss stakeholder views and our response to them.

Our definition of effective competition

3.8. In our assessment framework, we will consider competition to be effective if there are no significant barriers to consumers being able to access, assess and act on information about the products and services they may want, thereby driving rivalry between firms to win and retain customers. We expect effective competition to deliver fair outcomes for consumers in terms of what matters to them.

3.9. Our interpretation of fair outcomes does not mean that all consumers receive the same outcomes, but it does mean that consumers are treated according to certain principles, including but not limited to:¹⁴

- Consumers not being overcharged because firms are making excessive profits or passing on inefficient costs.¹⁵ This is a particular concern where consumers are less active in the market.
- Consumers being offered a reasonable range of tariffs.
- Consumers receiving good quality of service overall.

3.10. As the market develops we would expect consumers to be able to take advantage of new technology to meet their energy needs or contribute to a sustainable energy system.

Main themes in consultation responses on our definition of effective competition

3.11. Relating to our definition of effective competition, stakeholders raised:

¹⁴ For example, see Ofcom (2019) "[Making communications markets work well for customers: A framework for assessing fairness in broadband, mobile, home phone and pay-TV](#) "

¹⁵ In economics, a firm is productively inefficient if it is not producing a good or service at the lowest possible cost. For a discussion of productive efficiency, see for example Tirole, J. (1988) *The Theory of Industrial Organization*.

- (a) A view that we should be more explicit about the role engagement plays in driving competition, and that engagement is more than switching; it is also about being informed and empowered.
- (b) Concerns over the subjectivity of the proposed definition, particularly around what we mean by good outcomes.

Our view on theme (a): the role that engagement plays in driving competition and consumer information and empowerment

- 3.12. There are a range of different ways that consumers can engage with the retail energy market. These include engaging directly themselves by searching for the best deals or alternatively engaging by proxy, for example through third party intermediaries and automatic switching services. Both of these forms of engagement drive competition, and our definition requires that consumers are able to engage in these different ways.
- 3.13. Our definition requires that there are limited barriers to consumers engaging with the market and that the competitive process should be capable of delivering fair outcomes for consumers. Less active consumers should be treated fairly and, as discussed below, there may be additional protections in place for certain groups of customers, including those in vulnerable situations.¹⁶ These protections are subject to a separate review as stated in Section 9 of the Tariff Cap Act.
- 3.14. Since the CMA's Energy Market Investigation identified weak customer response and low engagement in the domestic retail energy market, we have been working to implement a number of measures to make engagement in the market easier for consumers (eg, consumer trials). We want to ensure that consumers are able to:
- Access information about their energy needs and the products and services that will meet these needs. Information can be accessed via many different channels (eg, directly from suppliers, websites, apps, smart meters and in-home-displays etc).

¹⁶ However, consumer vulnerability should not be equated with low engagement. While many consumers in vulnerable situations face additional barriers to engagement, they may still be highly engaged.

- Assess this information.
- Act on the basis of this information directly or via an intermediary. This could be about changing tariffs or not, as long as it is a deliberate choice.

3.15. We will examine where there are barriers in accessing, assessing or acting on information as part of our assessment.

Our view on theme (b): what does good outcomes mean?

3.16. Following stakeholder feedback, we have made our definition more explicit about what we mean by 'good outcomes'. We have revised it to be about consumers being treated fairly. Our above definition sets out some principles describing what we mean by fair outcomes. We recognise that competition will generate different outcomes for different consumers, where some groups of consumers, such as the more engaged, may benefit more than others. However, for competition to be effective it should be capable of delivering fair outcomes to consumers in terms of what matters to them, as outlined above in paras 3.8 and 3.9.

The conditions for effective competition

3.17. As set out in our discussion paper,¹⁷ we will look at three broad conditions that we expect to be in place for effective competition to develop in the supply of domestic contracts. Each of these three conditions will be considered "in the round" in our assessment. They will be considered jointly and may be met individually to varying degrees.

Condition 1: Structural changes to facilitate competition

3.18. Condition 1 requires that structural changes are facilitating or can be expected to facilitate the competitive process. These structural changes include those from government, Ofgem, and the wider market.

¹⁷ Ofgem (2019) "Discussion paper: [Developing a framework for assessing whether conditions are in place for effective competition in domestic supply contracts](#)"

Main theme from consultation responses on Condition 1

3.19. Stakeholders requested more detail on the structural changes that we will consider in our assessment and how we will measure the impact they have on the competitive process, including accounting for differences in their implementation timelines.

Our view on stakeholders' request for more detail on structural changes

3.20. Our assessment will consider the progress of a range of structural changes intended to improve the functioning of the market for domestic supply contracts. These changes come from several sources including the government, Ofgem and the market itself. We will also consider developments by energy service providers of new ways of engaging with the market (eg, automatic switching services).

3.21. Within this wide group of structural changes, we are explicitly required by the Tariff Cap Act to consider the progress of the smart meter roll-out for domestic consumers. Smart meters should facilitate the competitive process by giving consumers both real-time and historic information on their energy use, allowing them to make more informed choices on energy use, tariffs and suppliers. Smart meters will remove many of the specific engagement barriers faced by customers and make meter type less of a driver of variations in costs to serve (for example, prepay and credit will no longer need different meters). BEIS is currently consulting on proposals to help inform the policy framework for energy suppliers to continue installing smart meters after 31 December 2020, when the current rollout duty ends.¹⁸

3.22. Smart meters facilitate innovation in service and product offerings in the market, thereby incentivising consumers to take advantage of the benefits that monitoring and controlling energy use can provide and finding ways to save money (through better deals for example). Smart meters also pave the way for electricity settlement reform introducing market-wide half-hourly settlement, allowing for a better link between supplier costs and the consumption profile of customers.¹⁹

¹⁸ <https://www.gov.uk/government/consultations/smart-meter-policy-framework-post-2020>

¹⁹ Currently, most customers are settled on a 'non half-hourly' basis, as they have not had meters

- 3.23. Another important structural change that we will be considering is our Switching Programme,²⁰ which includes the creation of a new dual fuel switching service (Central Switching Service). The current switching process is too slow and is prone to error. Faster and more reliable switching will improve the experience of individual consumers and will help consumers feel more confident and empowered to engage in the market.
- 3.24. In addition to increasing engagement, the Switching Programme is also expected to improve the functioning of the competitive process by reducing barriers to entry for new entrants to the market (eg, reducing the extent to which the incumbent supplier can affect a switch away from it). The programme entered the 'design, build and test' phase this year,²¹ and is expected to go live in summer 2021.
- 3.25. Following our Supplier Licensing Review earlier this year, we have introduced new entry requirements for prospective suppliers that will help ensure that new entrants are well prepared to fulfil their commitments to consumers, with sufficient financial and operational resources in place.²² New entrants will also have had to provide a 'statement of intent' around compliance with license obligations, in particular with regard to customer service. These new requirements should act to increase customer confidence and trust in the market. We discuss this structural change in more detail in the discussion of Condition 2 below.
- 3.26. Our successful consumer trials give us important information on the drivers of consumer engagement. These trials have tested a number of interventions to prompt engagement, with the majority being letters and emails sent to customers on default energy tariffs to make them aware of better deals. For example, our simplified collective switch trial that ran between February and April 2018 incentivised more

that can record consumption or export in each half-hour period. They are settled using estimates of when they use electricity, based on a profile of the average consumer usage. With the implementation of half-hourly settlement, we would expect to see tariff innovation and, in particular, development of time of use tariffs. See Ofgem (2018) "[Market-wide Settlement Reform: Outline Business Case](#)", 17 August 2018

²⁰ See Ofgem (2019) "[Decision. Switching Programme: Full Business Case](#)", 14 May 2019

²¹

https://www.ofgem.gov.uk/system/files/docs/2019/06/switching_programme_newsletter_issue_7.pdf

²² Ofgem (2019). "[Decision: Supplier Licensing Review: Final proposals on new entry requirements](#)", 11 April 2019

than one in five disengaged customers on poor value deals to switch, with average savings of around £300. Unlike other collective switches, customers did not have to provide complicated information about their existing tariff to see a personalised savings calculation, making it easier to start a switch.²³ An important insight here is that the more steps that are removed from the switching process, the more likely engagement is.

3.27. Overall, our consumer trials show that energy customers respond most to communications which are simple and short, easy to understand, attention grabbing, personalised, and make clear exactly what the consumer needs to do.²⁴

3.28. The Future Energy Retail Market Review, which we are doing jointly with the Department for Business, Energy and Industrial Strategy (BEIS), 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.²⁵ Where appropriate, we will incorporate any structural reforms proposed by the review into our framework. The Future Energy Retail Market Review may also recommend complementary reforms that work alongside the reforms being developed by Ofgem and the government.²⁶ We will consider these reforms to the extent that they align with our assessment timelines. To ensure consistency, the set of structural changes that we consider for our framework will be updated regularly with developments under the Future Energy Retail Market Review.

3.29. Our assessment will account for the fact that the structural changes differ in their implementation periods. Structural changes that are implemented sooner will have a greater impact on our overall assessment (all other factors staying the same). Where possible, we will also account for the fact that structural changes cannot be assessed in isolation.

²³ See Ofgem (2018) "[Active Choice Collective Switch Trial: Final Results](#)".

²⁴ Ofgem (2019) "[Report: What works in increasing engagement in energy tariff choices?](#)".

²⁵ Department for Business, Energy and Industrial Strategy (2019), "[Future Energy Retail Market Review: overview](#)".

²⁶ Ofgem, Department for Business, Energy and Industrial Strategy (2019), "[Flexible and responsive energy retail markets](#)".

Condition 2: Well-functioning competitive process

3.30. Condition 2 requires that the competitive process in the domestic retail energy market should be expected to work well in the absence of the cap. For example:

- Consumers should be readily able to access, assess and act on 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 are empowered, through having confidence and trust in the market, and encouraged to engage.
- Efficient energy providers should be able to finance their operations, including making a normal profit.
- The entry and exit of firms is a feature of competitive markets as it incentivises them 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 should be well prepared to meet their commitments.
- There should be no material concerns about anti-competitive behaviour by market players, such as the abuse of unilateral market power over less active consumers or other practices that distort competition.²⁷

Main themes from consultation responses on Condition 2

3.31. The key themes on Condition 2 from stakeholder responses were as follows:

- (a) Analysis of the competitive process needs to recognise the different costs faced by large, medium and small suppliers.
- (b) Encouraging engagement requires price differentials.

²⁷ For further examples see CMA (2017), "[Market Studies and Market Investigations: Supplemental Guidance on the CMA's approach](#)".

- (c) Need for more elaboration on the balance between encouraging entry and the sustainability of business models.
- (d) It would be too high a burden of proof to demonstrate no anti-competitive behaviour.
- (e) The assessment may benefit from cross-sectoral comparisons.

Our view of themes (a) to (e)

- 3.32. We recognise that suppliers may differ in the costs they face, for example due to differences in customer base and policy costs. Where appropriate, our assessment of indicators of the competitive process will draw on data that can be disaggregated by supplier size. We collect a range of indicators on the competitive process, such as market share data, that can be disaggregated by large, small and medium supplier.
- 3.33. There are many drivers of consumer engagement, including price, quality of service and other factors such as reputation and environmental credentials. While price differences across products and providers can incentivise consumers to engage, they are only one part of the story.
- 3.34. Competitive markets are characterised by the entry and exit of firms, with the competitive process working so that the most efficient firms stay in the market. Following our Supplier Licensing Review earlier this year, we have introduced new entry requirements for prospective suppliers.²⁸ A well prepared entrant should be able to demonstrate to us, at the point of licensing, that they have planned their financial and operational resources for entry into the supply market and that they are prepared to meet the costs they will face (eg, under the government / environmental obligations and other industry costs). To the extent that a consumer's willingness to switch suppliers is determined by the risks that they perceive in switching, the new entry requirements placed on new entrants may encourage consumers to switch to suppliers with new, innovative, business models.²⁹

²⁸ Ofgem (2019). "[Decision: Supplier Licensing Review: Final proposals on new entry requirements](#)".

²⁹ Early evidence suggests that those who have been through an unwanted Supplier of Last Resort (SoLR) experience may be less likely to engage in the future.

- 3.35. Following stakeholder responses, we recognise that that it would be too high a burden of proof to demonstrate that there is no anti-competitive behaviour. We have therefore modified Condition 2 to state that there should be no material concerns about anti-competitive behaviour.
- 3.36. Some stakeholders suggested that we assess how the competitive process in the domestic retail energy market compares with other sectors, in order to identify how competitive the domestic retail energy market retail is. Any comparison would need to be on a like-for-like basis, as far as possible, and would involve forming a view on how effective competition is in other sectors, which is not part of this exercise. However, where we do have cross-sectoral data we may take this into account in our assessment (eg, our consumer survey data contains cross-sector information).

Condition 3: Fair outcomes for consumers

- 3.37. Condition 3 requires that the competitive process should be expected to deliver fair outcomes for consumers in terms of what matters to them, including prices, quality of service, tariff choices to meet needs, and the ease and reliability of the switching process.³⁰ This recognises that competition will generate different outcomes for different consumers, but requires that consumers are treated fairly, for example including not being overcharged due to prices being set high for excessive profits and/or due to inefficient costs being passed on. Competition will not always deliver the best outcomes for all consumers but should deliver fair outcomes. Some additional protection may be necessary to ensure that consumers are receiving fair deals, for example for consumers in vulnerable situations (see para 3.39).³¹
- 3.38. The outcomes that we will assess include the prices that consumers face, the quality of service that they receive, the range of products that are available to meet their needs and the ease and reliability of switching energy tariff and supplier. We will

³⁰ For example, our consumer trial results show that consumers care about having a simple, guided process to switching. See Ofgem (2019) "Report: What works in increasing engagement in energy tariff choices?".

³¹ Earlier this year we consulted on our [Consumer Vulnerability Strategy \(CVS2025\)](#), which builds on the extensive work to identify and protect vulnerable consumers that has taken place since our 2013 Consumer Vulnerability Strategy. Our dynamic definition of vulnerability recognises that the risks individuals face can stem from their characteristics or circumstances and the market itself, and how they interact.

assess the potential extent of price dispersion, and whether consumers who are less active in the market would face excessive prices.

3.39. In relation to protection for domestic consumers, Section 9 of the Tariff Cap Act makes a separate provision for Ofgem to carry out a review into the pricing practices of domestic suppliers and to consider whether there are categories of domestic consumers that would require protection against excessive charges after the termination of price caps on default tariffs. This review should take into account consumers that may be vulnerable, financially or otherwise. If the review concludes that protection is required, the necessary steps should be taken to put this protection in place.³² Ofgem is determining what arrangements should be made to ensure this review is in step with our assessment as part of the requirement under Section 7, and that it is carried out in a timely manner should it need to be.

Main themes from consultation responses on Condition 3

3.40. The main themes across stakeholder responses relating to Condition 3 are as follows:

- (a) The proposed framework should acknowledge that competition will not address distributional outcomes.
- (b) The framework should recognise that low prices might not equate with good consumer outcomes.

Our view on themes (a) and (b)

3.41. We recognise that competition will generate different outcomes for different consumers. For example, consumers who shop around may get cheaper deals than those who do not. When looking at structural changes to improve the functioning of the competitive process, we may consider distributional impacts.

3.42. Consumer outcomes are driven by more than just price, and our framework recognises this. Our framework incorporates tariff choices, quality of service,

³² See [Domestic Gas and Electricity \(Tariff Cap\) Act 2018, p.6](#)

switching and prices (among other aspects) and we recognise that a balance will need to be achieved when assessing these outcomes. For example, if lower prices coincide with a fall in quality of service this may not be viewed as a good outcome for consumers.

4. How our framework evaluates the competitive process

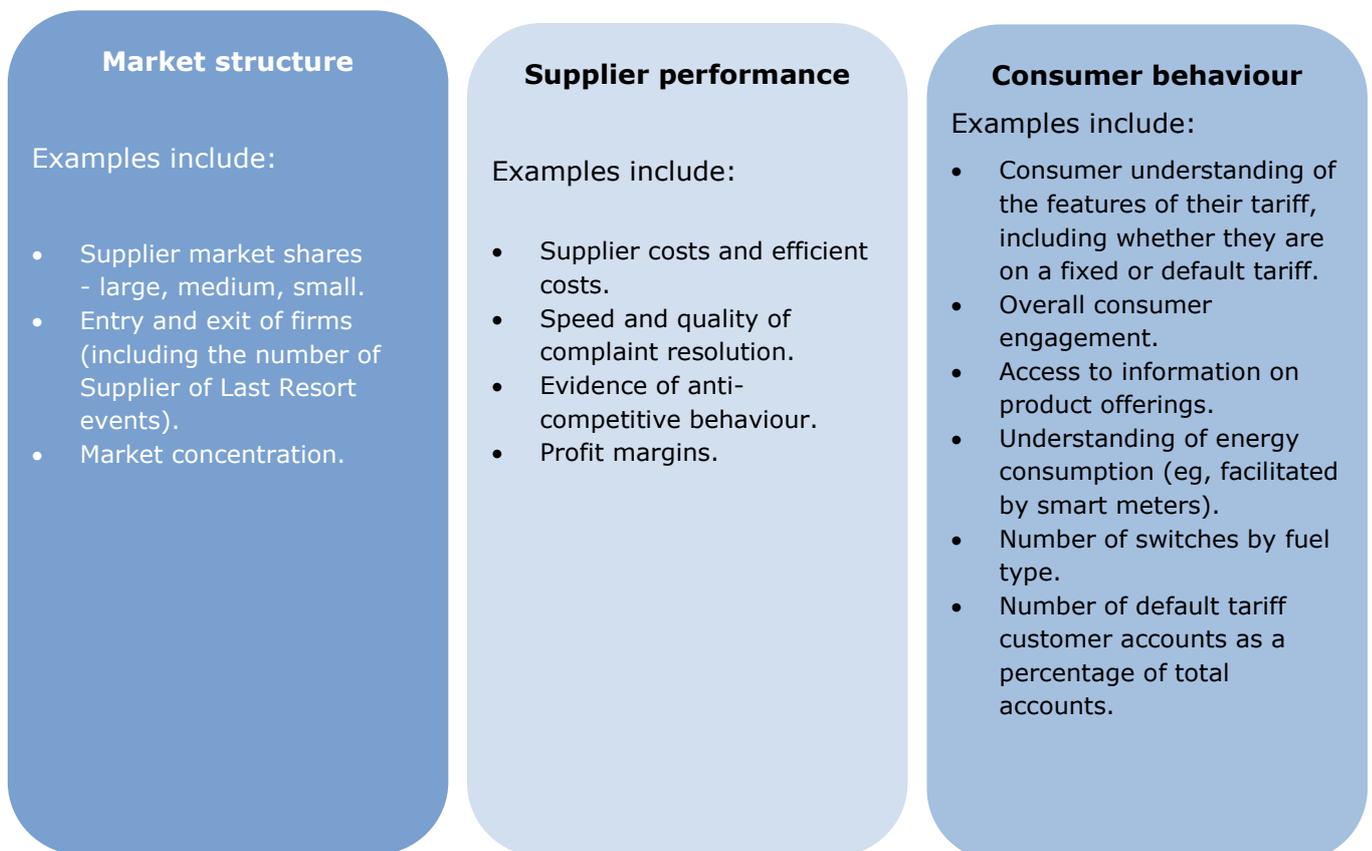
Chapter summary

In this chapter, we set out how we will monitor and assess the competitive process in retail energy markets. We also discuss stakeholders' views.

An overview of how we will monitor the competitive process

4.1. The indicators we will use to determine how well the competitive process is working (Condition 2 in our assessment) fall into three broad categories: indicators related to market structure; indicators on suppliers' performance; and measures of how consumers are responding to market developments. Figure 3 provides some examples of the indicators.

Figure 3: Indicators of the competitive process



- 4.2. We will not set specific targets or thresholds for each of the indicators, and there are several reasons why we think it would not be appropriate to do so:
- 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 will be assessing.
 - ii. Indicators may be interdependent such that an increase in one leads to a decrease in another (or vice versa). For example, higher engagement levels may result in inefficient suppliers leaving the market and/or increased opportunity for new entrants.
 - iii. It is not clear whether an increasing or decreasing rate for some indicators should always be interpreted as a positive outcome. For example, if switching rates increase this could reflect a greater level of engagement, but it could also indicate poor service quality that leads consumers to devote considerable effort to finding a reliable supplier.
 - iv. Some of the indicators may be affected by the default tariff cap thus making the interpretation of changes in some of the indicators complex.
- 4.3. That is why we will assess all indicators together and in the round to make an informed judgement as to whether the conditions are in place for effective competition in the supply of domestic retail contracts.³³

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

- 4.4. Our impact assessment of the default tariff cap suggests that it 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.³⁴ We also reviewed international case studies and found evidence that in

³³ See NAO (2008), "[Protecting consumers? Removing retail price controls](#)", Report by the Comptroller and Auditor General.

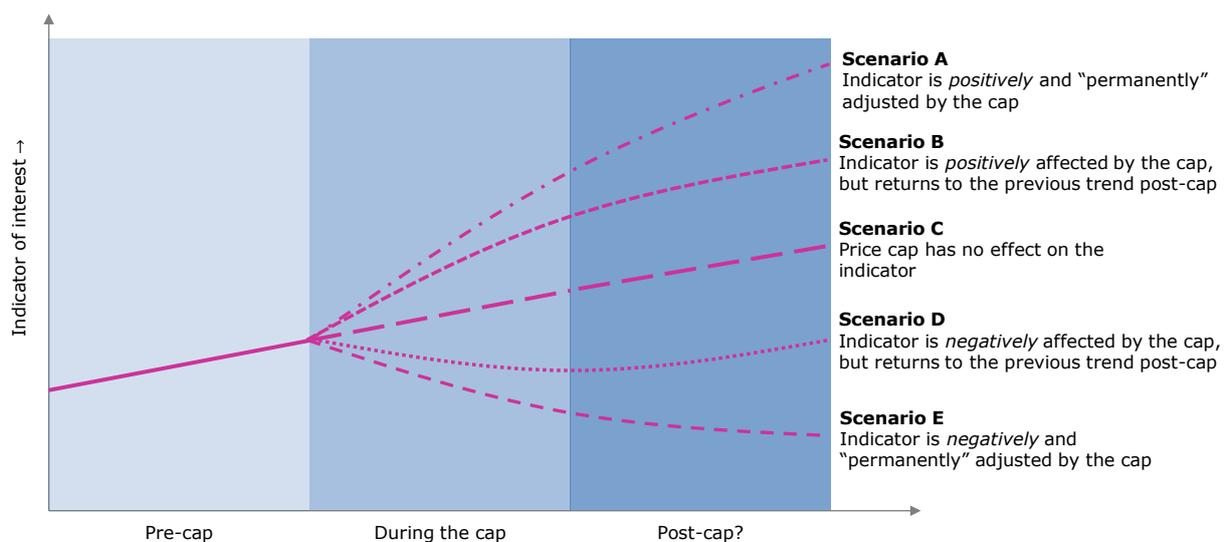
³⁴ Ofgem (2018), "[Default Tariff Cap: Decision Final Impact Assessment](#)", pp 90 – 102.

Australia a price cap had reduced differences in tariff prices, switching rates and levels of innovation, whilst in Northern Ireland price caps have had a limited impact on switching rates and rivalry between firms.³⁵

4.5. Given that some of the indicators we are interested in could be affected by the presence of the cap, we need to find a way to identify and account for the impact of the cap on these indicators and determine whether these effects would persist if the cap was lifted. There is a range of analytical techniques that we may use to do this and we discuss them in more detail in Appendix 3.

4.6. Figure 4 below illustrates some potential (non-exhaustive) scenarios of how an indicator may be affected by the cap.³⁶

Figure 4: Illustrative effects of the price cap on indicators



Indicators of the competitive process: Market structure

4.7. Indicators of market structure include the market shares of suppliers, as well as the dynamics of suppliers entering and exiting the market. Through the process of competition, we would expect suppliers with innovative business models or more

³⁵ Ofgem (2018), “[Default Tariff Cap: Decision Final Impact Assessment](#)”, pp 138 – 139.

³⁶ The figure does not assume that increases or decreases in a given indicator contribute towards or against effective competition.

efficient technologies to increase their market share, potentially resulting in the exit of less-efficient firms.

Main themes from consultation responses on market structure

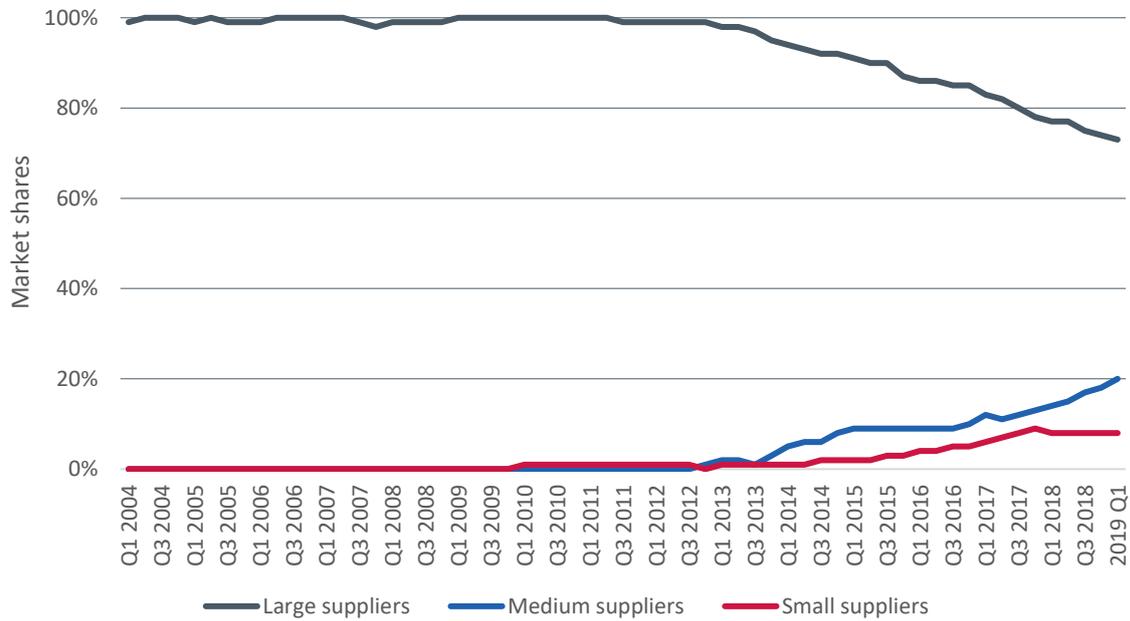
4.8. The main themes across stakeholder responses relating to market structure indicators are:

- (a) Market share data could be conditioned by supplier size, giving the respective shares within the group of large suppliers, and medium and small suppliers
- (b) Ofgem's recent changes to supply licenses have made entry conditions more stringent, which may lower the rate of entry.

Market shares

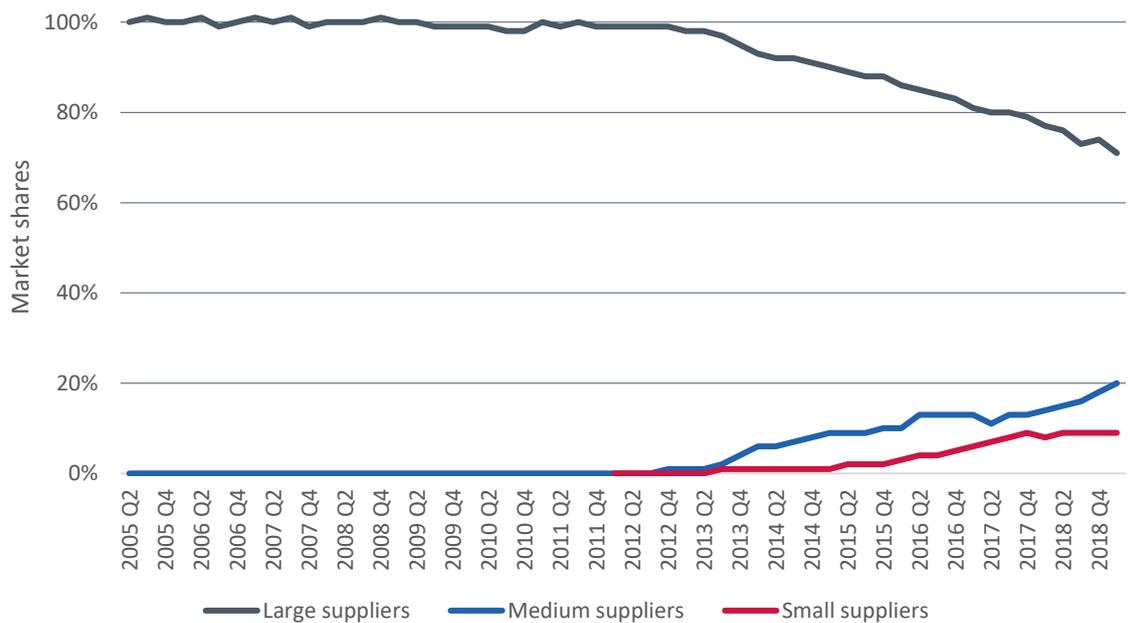
4.9. We collect market share data that can be broken down by supplier size and, in even greater detail, by specific supplier. We will assess the direction of travel of market shares broken down by large, medium, and small suppliers. We will also look at customer flows between and within these groups. We have illustrated market share data in Figure 5 (for electricity), Figure 6 (for gas) below, while customer flows are illustrated in Figure 7.

Figure 5: Market shares for electricity supply, 2004-2019.



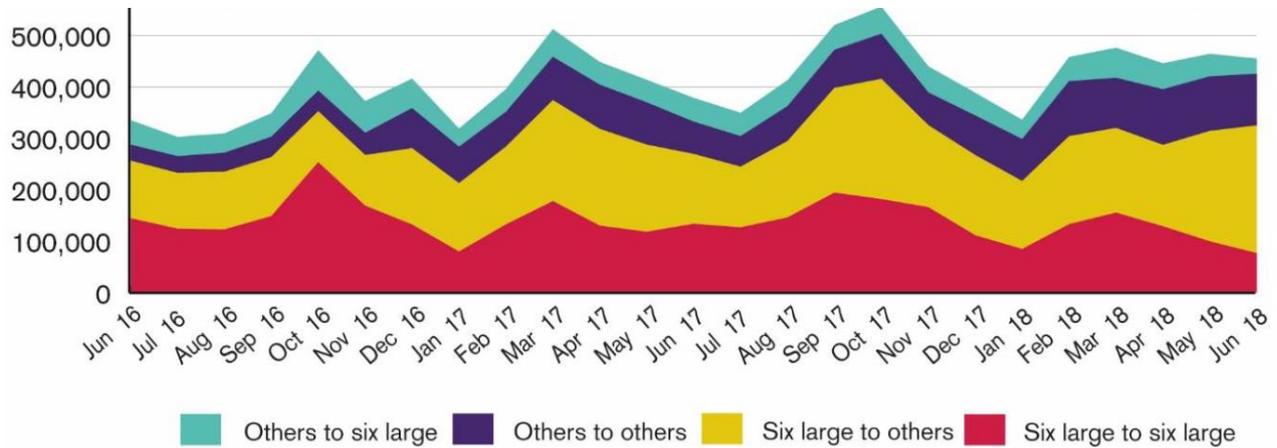
Source: Ofgem analysis of electricity distribution network operator reports. Information correct as of: July 2019.

Figure 6: Market shares for gas supply, 2004-2019



Source: Ofgem analysis of Xoserve reports. Information correct as of: July 2019

Figure 7: Customer flows between supplier types: large six and others

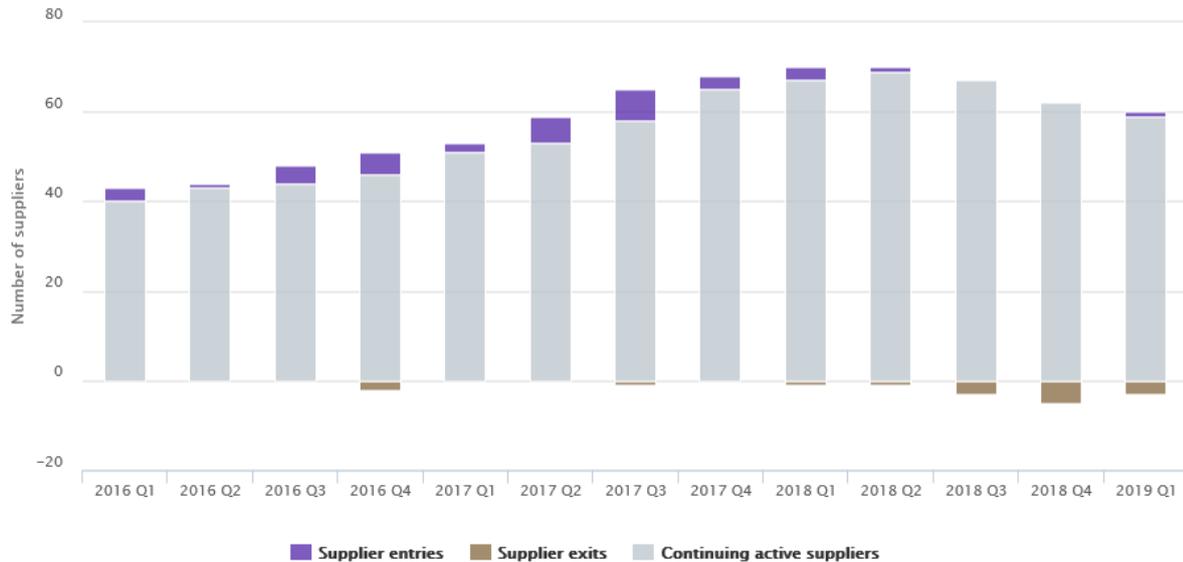


Source: Ofgem’s analysis of Distribution Network operator data and Xoserve data

Entry and exit of suppliers

4.10. We collect quarterly data on the number of supplier entries and exits (see Figure 8 below). We will consider the reasons for exits as well as the market conditions that encourage entry. While important, we do not see market entry as, intrinsically, a good thing and will take into account effects of the changes made following our Supplier Licensing Review. This Review aims to ensure that suppliers entering the retail energy market are sufficiently prepared to fulfil their commitments.

Figure 8: Supplier entry and exit in the domestic energy retail market.



Source: Ofgem’s analysis of Distribution Network operator data and Xoserve data

Indicators of the competitive process: Supplier performance

4.11. Our assessment of the performance of suppliers will be largely based on financial considerations, including the costs that they face. It will complement our analysis of entry and exit, which gives information about the degree of commercial opportunity that exists.

Supplier costs: operating costs and efficiency

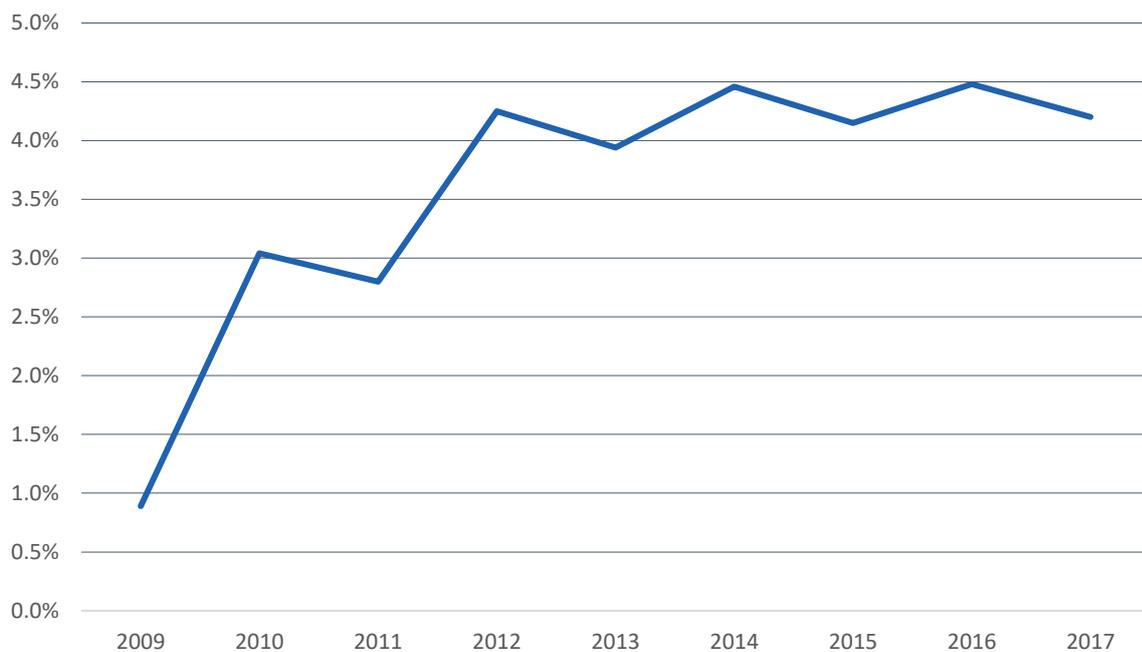
4.12. The default tariff cap was put in place to protect consumers from being overcharged and to encourage suppliers to become more efficient. This means that the costs suppliers face and how they pass these on to consumers will be part of our assessment. One way to measure efficiency is to use data on operating costs and customer base numbers, controlling for important factors that are affected by changes in customer base, such as costs to serve.

4.13. To facilitate our assessment, we will consider the use of numerical techniques to better understand how costs (and in turn prices) may evolve in the future. These techniques are widely used in the assessment of competition, for example when assessing the potential impacts of a merger.

Earnings before income and tax (EBIT) margins

4.14. We may also look at the underlying profitability of suppliers. Figure 9 illustrates the combined gas and electricity aggregate EBIT margins across the current large six suppliers. With recent changes in the make-up of the group of largest suppliers, we recognise that the profitability data from the Consolidated Segmental Statements will only cover a proportion of the market and, as such, will not be representative of the market as a whole. Therefore, we will consider whether we should request costs and revenue data from all or some groups of suppliers. Our assessment will take into account differences in costs and customer bases across all supplier types.

Figure 9: Aggregate EBIT margins of large six suppliers, combined gas and electricity, 2018



Source: Ofgem’s analysis of Consolidated Segmental Statements

Indicators of the competitive process: Consumer behaviour

4.15. Consumers drive the competitive process when they are empowered to engage with the market in a range of different ways, whether directly through searching for the best deals themselves or via proxy through third party intermediaries and automated switching services. In all of these cases it is important that consumers are able to access, assess and act on information to make an informed decision. Consumer

engagement should not be equated solely with switching. For example, a consumer may actively search the market but decide that the tariff they are currently on is the most appropriate one for their needs. What is crucial is whether or not it is a deliberate or active choice.

Consumer understanding of product offerings

4.16. Our consumer surveys collect data on the extent to which consumers understand the energy tariffs that they are currently on and the range of options available in the market. These include:

- Consumer understanding of what tariff they are on and whether it is a default tariff.
- Their overall levels of engagement, defined as having switched supplier, changed tariff or compared tariff with their own or other suppliers in the past 12 months.

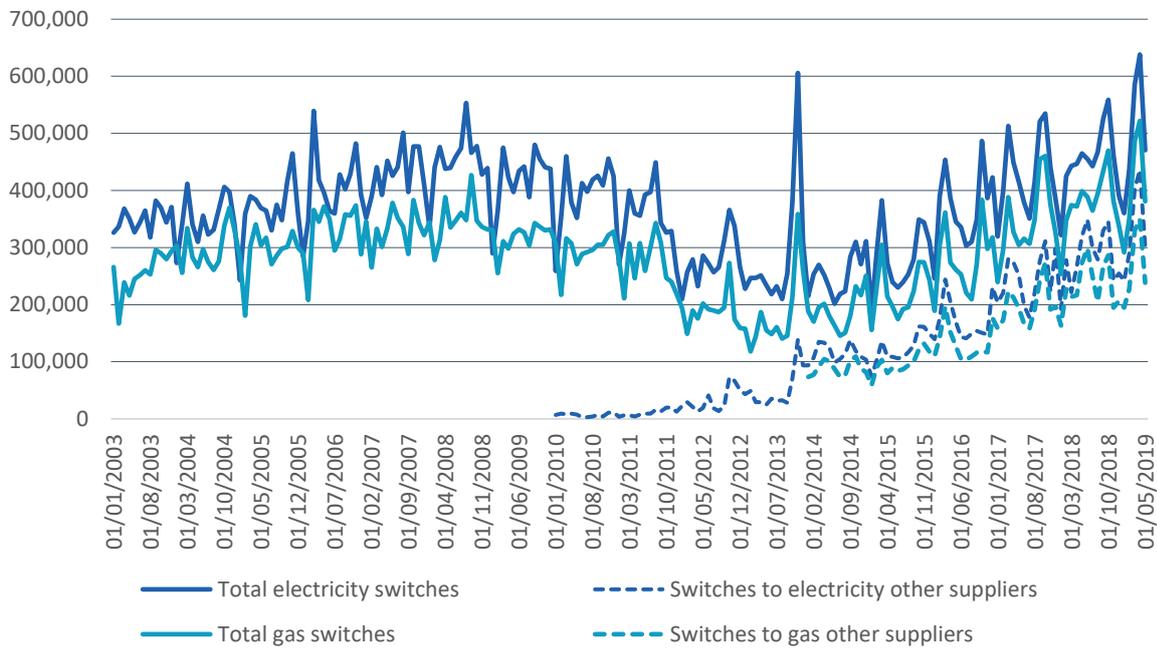
Switching data

4.17. We collect data on the number of switches per fuel type, and whether these switches are 'internal' to products offered by the same supplier or 'external' to a different supplier. This data, which can be used to calculate switching rates and the evolution of these rates over time, is illustrated in Figure 10.

Default tariffs as percentage of total accounts

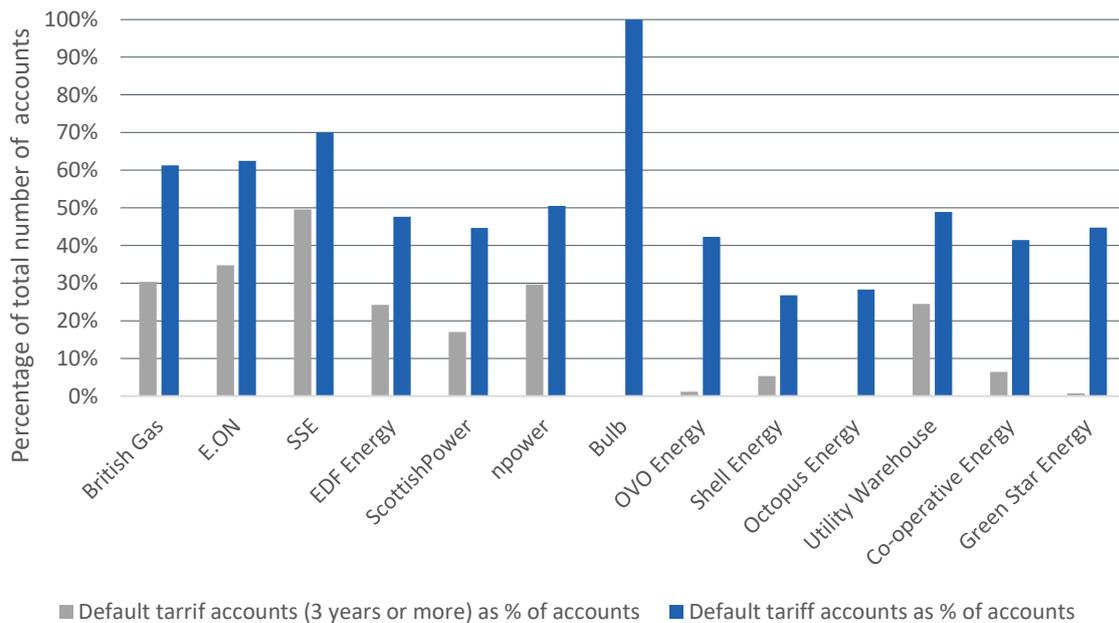
4.18. One indicator of consumer engagement is the type of tariff that they are on. In many cases, default tariffs may be associated with lower engagement (though this may not always be the case, for example some suppliers may only offer a default tariff). Our assessment will draw on data on the proportion of customer accounts that are default tariffs and on the length of time that customers have been on those accounts. Figure 11 provides a snapshot of this data, correct as of July 2019.

Figure 10: Number of domestic customers switching supplier by fuel type (GB)



Source: Ofgem analysis of data from electricity distribution network operators (DNOs) and Xoserve. Information correct as of: August 2019

Figure 11: Default tariff accounts as a proportion of total accounts, July 2019



Source: Suppliers. Information correct as of: July 2019.

5. How our framework evaluates consumer outcomes

Chapter summary

In this chapter, we set out how we will assess key drivers of consumer outcomes, including, but not necessarily limited to:

- prices and price differentials.
- quality of service.
- tariff choice.
- switching process.
- consumer trust and confidence.

- 5.1. Consumer outcomes are driven by multiple factors. Consumers care about the price they pay for their energy, the quality of service they receive from their supplier, the availability of tariffs to suit their needs, the ease with which they can switch to better deals and whether they are able to trust their supplier and the market to treat them fairly.
- 5.2. These drivers of consumer outcomes are not independent or mutually exclusive. They relate to each other in potentially complex ways that will differ across consumers. As such, our framework will consider the direction of travel of these indicators in making an overall assessment. Below we set out how we will monitor and assess the direction of travel of these indicators. However, our assessment will not be restricted to these indicators. Where applicable, we discuss how we have taken account of stakeholder views on the appropriateness of a given indicator and the challenges involved in assessing it.

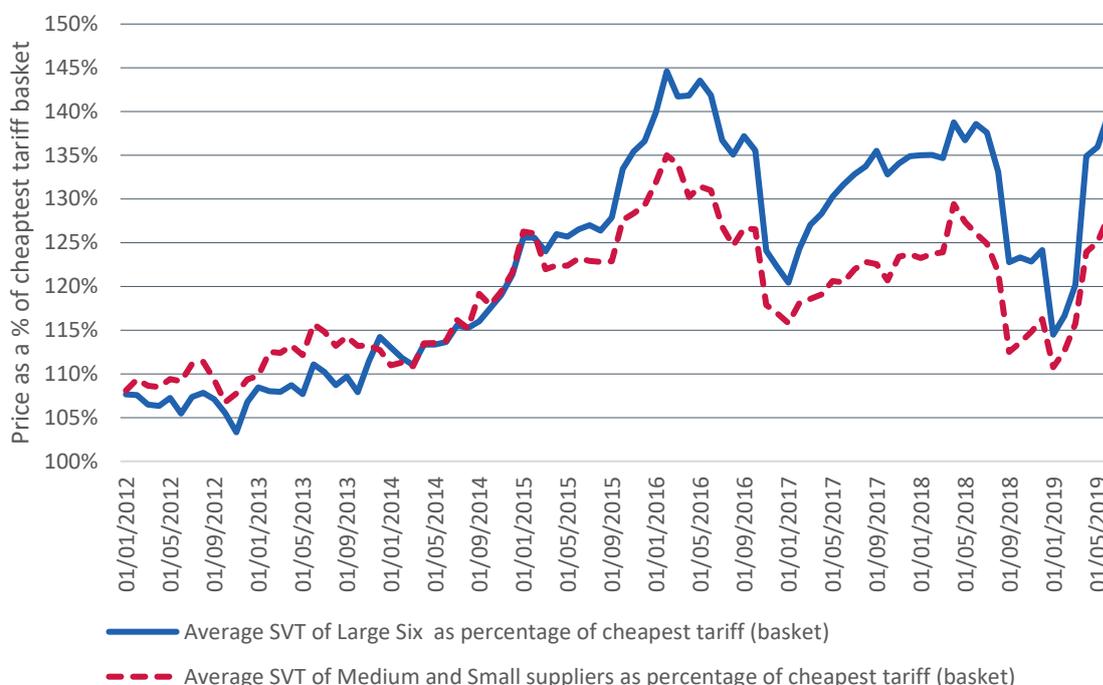
Price and price differentials

- 5.3. Consumers care about the price that they pay for their energy. It directly impacts their budget and therefore affects how much they can consume and save over a given period of time. The significant differences between default tariffs and fixed tariffs that have arisen over time has disproportionately affected those who are less active, and often in vulnerable situations. This is because differences in levels of engagement with the market have led to different pricing strategies and tariff

offerings, with less-engaged or less active consumers on default tariffs typically paying more than engaged or active consumers on fixed tariffs.

5.4. Figure 12 provides an overview of how the average price of standard variable tariffs compares with a price based on the basket of the ten cheapest tariffs in the market, over the period 2012 to 2019. In our assessment, we will use the basket of ten cheapest tariffs, rather than the very cheapest tariff, to avoid unrealistic comparisons with tariffs that only a limited number of customers can access, outliers or unsustainable offers.

Figure 12: Price differentials - average SVT as a proportion of cheaper tariffs



Source: Ofgem analysis of Energylinx (Until May 2017) & Energyhelpline (June 2017 onwards). Information correct as of: August 2019.

Main themes in consultation responses about price differentials

5.5. Stakeholder views around the assessment of price differentials were as follows:

- (a) Need clarification about what price differentials refer to in this context and how will they be used in the analysis.

- (b) Caution should be exercised when looking at price differentials. Many of the lowest prices on the market may be unsustainable or using a loss-leader strategy to win customers. Suppliers of different sizes face different costs, for example due to their customer base and policy costs.
- (c) There will likely be a trade-off between narrowing price differentials and lower prices overall. What is the acceptable price differential?
- (d) Lower prices do not guarantee better outcomes.

Our view on theme (a): price differentials and when they are a concern

- 5.6. Price differentials are in general a feature of competitive markets. They are not necessarily a concern, particularly where they predominantly reflect differences in costs. In the supply of domestic contracts, the price differential between default tariffs and fixed tariffs has been a concern because customers on default tariffs have been overcharged for their energy needs due to their inactivity in the market. This overcharging was a result of price discrimination (ie, charging more for standard variable tariffs than could be justified by the differences in costs between standard variable tariffs and fixed tariffs) and inefficient costs.³⁷
- 5.7. While firms seek to strike a balance between cost-reflective pricing and a desire to win customers, this should not result in less active consumers being overcharged, especially as many are vulnerable and are less able to overcome any barriers to engagement.³⁸ We want to ensure that less active consumers pay a fair price for their energy.
- 5.8. In our assessment, we will be mindful that price differentials can be a sign of both effective or ineffective competition. A market with a wide differential that is driven by overcharging less active consumers is harmful to these consumers and indicative of ineffective competition. In contrast, where this differential is driven through

³⁷ In economics, a firm is productively inefficient if it is not producing a good or service at the lowest possible cost. For a discussion of productive efficiency, see for example Tirole, J. (1988) The Theory of Industrial Organization.

³⁸ See Financial Conduct Authority, FCA (2018). "[Price discrimination in financial services: How should we deal with questions of fairness](#)", June 2018

vigorous competition for active consumers (with suppliers potentially charging below costs for a period³⁹) it can be a sign of effective competition. Similarly, a market with a small differential may be indicative of weak competition in the engaged part of the market. We recognise that any examination of price differentials has to be on a like-for-like basis as far as possible. Our assessment will take into account differences in costs due to differences in customer base and policy costs. Where possible, we will use data that can be disaggregated by large, medium and small supplier.

Our view on theme (c) and (d): trade-off between price differentials and lower prices

- 5.9. It is not clear that there is a trade-off between price differentials and lower prices. For example, the narrowing of price differentials may coincide with a fall in average prices, particularly if this narrowing is driven by cost efficiencies that are passed through to consumers. What is important in the context of effective competition is that an increase in price differentials is not driven by less active consumers being overcharged.
- 5.10. We will not specify an 'acceptable' price differential. It is not clear that such a task would be possible or sensible, given the interdependence of the indicators we will be assessing. Moreover, lower prices do not necessarily result in better outcomes for consumers, particularly if they are at the expense of other important features such as quality of service. In our framework, we look beyond price and price differentials, and as part of our assessment, we will explore other key drivers of consumer outcomes.

Quality of service

- 5.11. The expectations that customers have of suppliers are largely transactional; most customers will not think about them or engage with them as part of their daily lives.⁴⁰ When they do engage with them they want to be provided with good customer service and accurate information about their energy use and billing. Customers want suppliers to be responsive to their needs and to provide them with simple and accurate information on their energy usage and billing in a timely

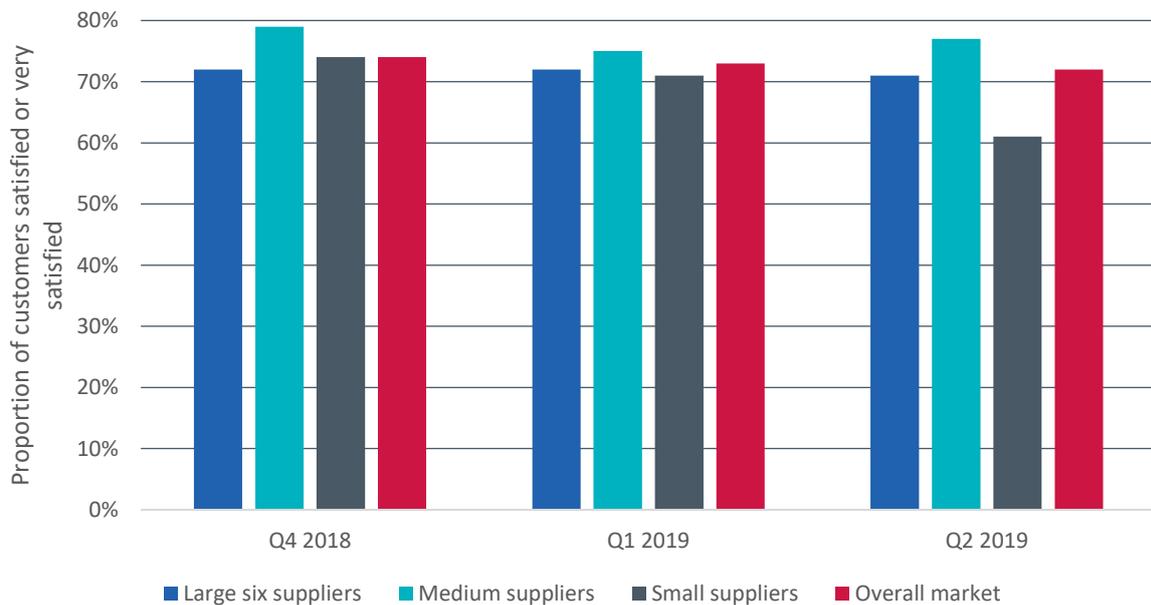
³⁹ Below-cost pricing may be part of a legitimate commercial strategy to grow and win customers.

⁴⁰https://www.ofgem.gov.uk/sites/default/files/docs/ofgem_consumer_panel_report_final_year_7_wave_1.pdf

fashion. Each of these aspects contributes towards the overall quality of service that a consumer experiences. We collect data on quality of service from a range of sources. These include customer complaints data from suppliers (published as part of our joint work with Citizens Advice and the Ombudsman), energy satisfaction survey data and other available sources. We will consider a combination of these metrics to understand changes in quality of service. The specific combination of data will depend on our view of what is the most accurate and representative way of assessing data from different sources.⁴¹

5.12. Figure 13 below illustrates some of the results from our quarterly energy satisfaction survey,⁴² which we commissioned in conjunction with Citizens Advice. Each quarter, 3,200 domestic energy consumers around Great Britain are surveyed, with 300 of these consumers being surveyed in person to capture the views of those who either do not have access to the internet or very rarely use it.

Figure 13: Customer satisfaction: Overall customer service (GB)



⁴¹ We are aware of approaches suggested in the academic literature, such as the “Overall Customer Service Score”: see Littlechild, S. (2019) “[Savings available in the retail energy market and the Overall Customer Service score](#)”, Energy Policy Research Group.

⁴² See <https://www.ofgem.gov.uk/consumers/consumer-research/research-surveys-household-consumers>

Source: Dedicated quarterly energy satisfaction survey commissioned in 2018 by Ofgem in conjunction with Citizens Advice.

5.13. We will also assess movements in key drivers of customer satisfaction, including ease of contacting a supplier, customer service and satisfaction with billing.

The main themes in consultation responses on quality of service

5.14. Stakeholder views from our discussion paper on quality of service and customer satisfaction were that:

- (a) There may be an interaction between quality of service and price, whereby lower prices result in poorer quality of service; and
- (b) The assessment of quality of service should differentiate between large, medium and small suppliers in the market.

Our views on themes (a) and (b)

5.15. The quality of service that a supplier provides forms part of the cost that determines, in part, the price it sets. Lower prices would not be considered a good outcome for consumers if they are not cost-reflective (ie, should be even lower) or are in other ways indicative of lower quality of service. It is for this reason that our analysis considers, in the round, a range of drivers of consumer outcomes, including both price and quality of service.

5.16. The data that we collect on customer satisfaction can be disaggregated by supplier type (large, medium, small). Whilst there is no obvious reason for differentiating quality of service based on the size of the supplier, we will make use of the disaggregated data in our assessment to highlight any salient differences.

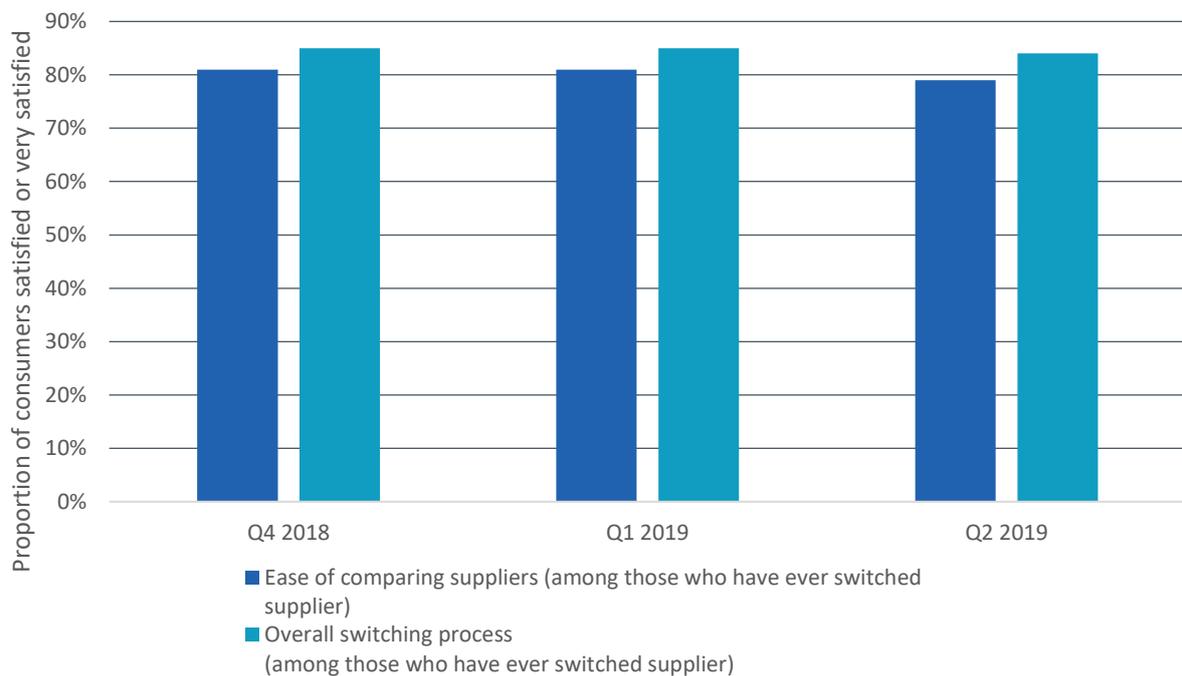
Switching process

5.17. The ease with which customers can change energy supplier can encourage or discourage engagement with the market. In assessing how the switching process affects consumer outcomes, we will use survey data on consumer experiences of the switching process itself and data on realised outcomes, such as average switching times.

Consumer experience of the switching process

5.18. We collect data on consumer perceptions and experience of the switching process through our quarterly energy satisfaction survey. For consumers who have switched supplier, the survey collects information on how easy they felt it was to compare and switch suppliers. The latest results are illustrated in Figure 14.

Figure 14: Consumer satisfaction with the switching process



Source: Dedicated quarterly energy satisfaction survey commissioned in 2018 by Ofgem in conjunction with Citizens Advice.

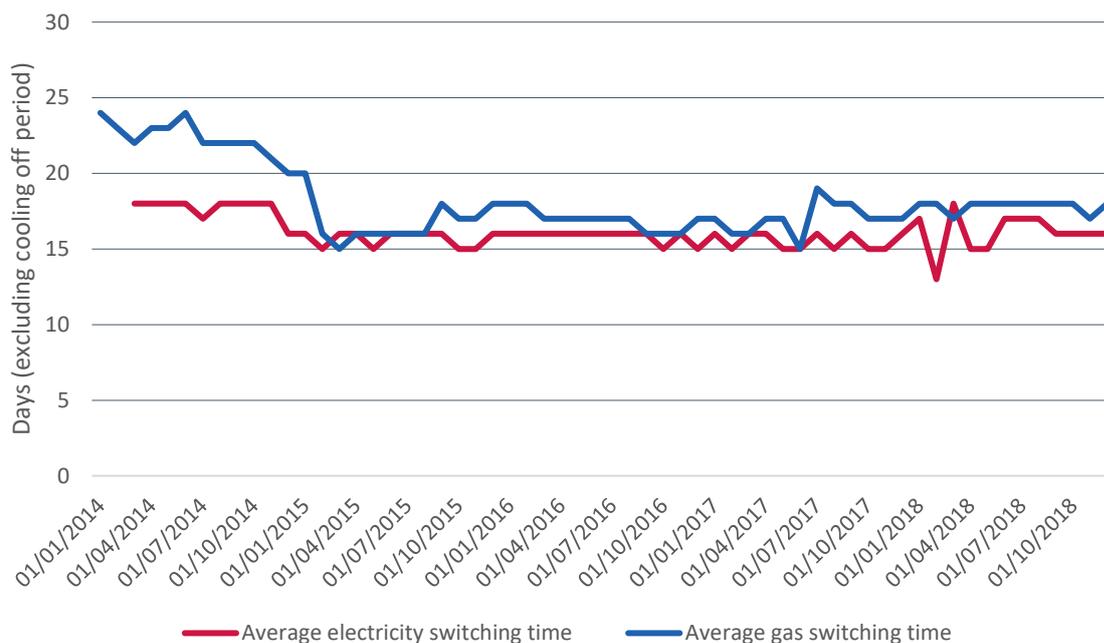
Switching times

5.19. The time it takes a customer to switch energy tariffs or providers successfully will be a useful indicator of how well the domestic retail market is functioning in the interest of consumers. While many customers may be more concerned about the reliability of switching, a lengthy switching process can disincentivise some customers from switching suppliers.

5.20. We will assess how average switching times have evolved over time and how we would expect them to continue to evolve in light of structural reforms aimed at

significantly improving the efficiency of the switching process, such as the Faster and More Reliable Switching programme.⁴³ Figure 15 illustrates average switching times for domestic customers since 2014, which have been fairly static due to statutory requirements.

Figure 15: Average switching times for domestic customers (GB)⁴⁴



Source: Ofgem analysis of electricity distribution network operator (DNO) and Xoserve (gas) data

Erroneous transfers

5.21. In some cases, the switching process may go wrong. Consumers may be erroneously transferred to the wrong supplier, causing inconvenience and potentially distress. Since 1 May 2019, consumers receive automatic compensation if they are mistakenly transferred to an incorrect supplier or the supplier is late in refunding a credit balance following a final bill. We collect quarterly data on the number of erroneous

⁴³ See <https://www.ofgem.gov.uk/publications-and-updates/switching-programme-full-business-case>

⁴⁴ Switching time is measured here by the number of calendar days it takes from when a supplier submits a switching request to the transfer taking place. We source our data from distribution network operators, so our analysis does not reflect the time taken by the supplier to submit a switching request, which may happen at the end or during the cooling-off period, nor the additional time to process the contract with the customer.

transfers and will consider this as part of our assessment of the impact of the switching process on consumer outcomes.

Trust and confidence

5.22. The interaction that consumers have with energy service providers, including suppliers and price comparison websites, can dramatically affect their trust and confidence in engaging with the energy market.

5.23. We collect data on consumer trust and confidence, for example from our annual Consumer Survey, which asks questions on the degree to which consumers trust market providers along a number of dimensions. This data can be disaggregated by region, age and income. The survey also compares levels of trust across different sectors, including communications, banking and insurance. For example, the survey data contains responses to the following questions:

- To what extent do you trust or distrust your energy supplier to (a) treat you fairly in their dealings with you? (b) provide clear and helpful information for you? (c) charge you a fair price.
- To what extent do you trust or distrust each to be fair in the way they deal with customers and citizens: energy suppliers; internet suppliers; banking; and finance.

5.24. Our assessment will draw on this data to assess how trust and confidence are evolving in the domestic energy market.

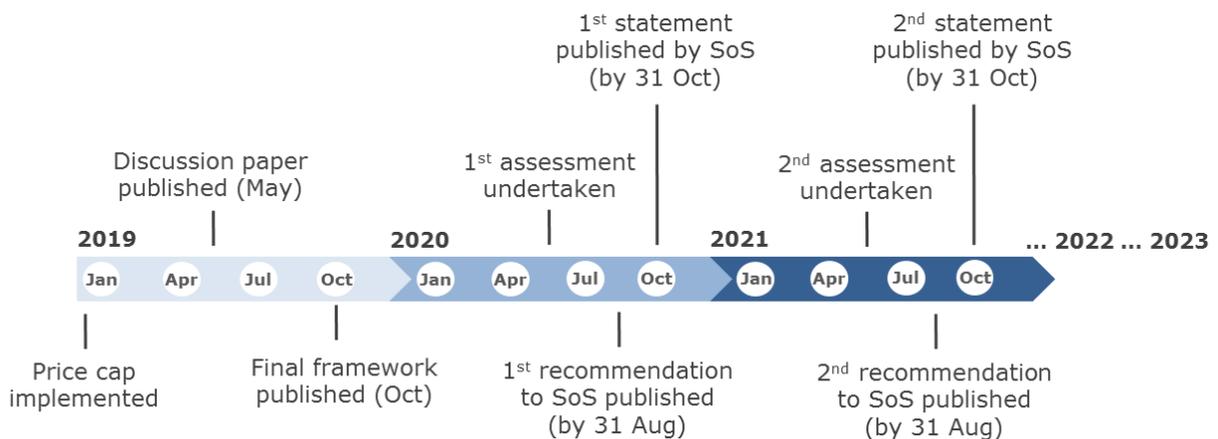
6. Next steps

Chapter summary

This chapter sets out next steps and key milestones.

- 6.1. In this decision document, we have set out our framework for assessing whether conditions for effective competition are in place for domestic supply contracts. We will use the framework to support our recommendation to the Secretary of State on whether the default tariff cap should continue in 2021 or not.
- 6.2. In accordance with the Tariff Cap Act, we will publish our assessment on or before 31 August 2020, including a recommendation to the Secretary of State on whether the default tariff cap should be extended to have effect in the following year. 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. The decision taken by the Secretary of State may or may not be consistent with our recommendation.

Figure 16: Key milestones



Appendices

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Appendix 1 - Uses of effective competition term in policy

Table 2: 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 the 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.”
<i>Financial Conduct Authority (FCA)</i>	<p>Promoting effective competition, March 2016</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 2 – 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 our assessment. Similarly, we may look to include further indicators that are not included in the below tables.

Table 3: Examples of process indicators for evaluating the conditions for effective competition

Theme	Indicator	Frequency	Source
Market structure indicators			
<i>Rivalry</i>	Market shares: - Large energy suppliers (> 5%) - Small and medium suppliers (<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	Quarterly	Ofgem
<i>Innovation</i>	Number of initiatives going through Ofgem’s regulatory sandbox	Monthly	Ofgem
<i>Innovation</i>	Number of in-home displays installed alongside smart meters	Annual	Ofgem
Consumer behaviour indicators			
<i>Engagement</i>	Overall engagement measures (compared tariffs and / or switched in past 12 months)	Annual	Ofgem
<i>Engagement</i>	Number of domestic customers switching by fuel type: - internal switching (with the same supplier) - external switching (between suppliers)	Quarterly	Ofgem
<i>Engagement</i>	Consumer understanding of what tariff they are on and its features	Annual	Ofgem
<i>Trust and confidence</i>	Proportion of customers who find it very or fairly easy to contact supplier	Quarterly	Ofgem

Theme	Indicator	Frequency	Source
Supplier performance indicators			
<i>Efficiency</i>	Earnings before income & tax (EBIT) margins	Annual	We currently collect data on supplier costs and will factor this data into our assessment. We will also consider requesting specific cost information from all or some suppliers.
<i>Efficiency</i>	Operating costs - per customer - relative to price cap allowance	Annual	
<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 4: Examples of 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 suppliers' customer service performance	Quarterly	Published as part of our joint work with Citizens Advice and the Ombudsman
<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

<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

Appendix 3 - Analytical techniques to identify the effects of the price cap

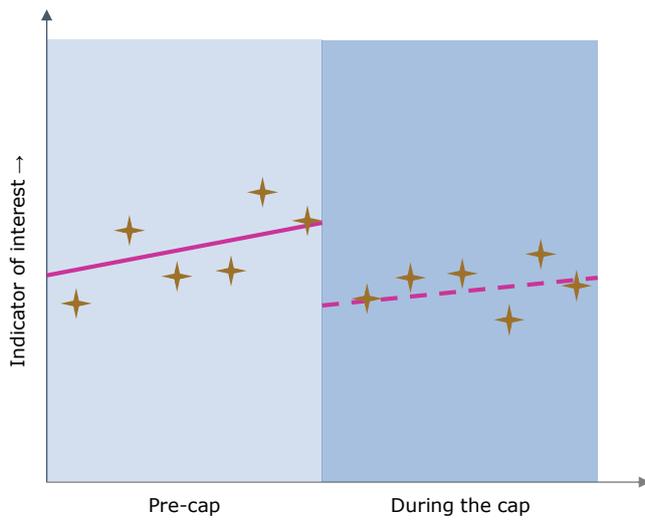
Testing for structural breaks

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 16 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 16: 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.