ofgem
Making a positive difference for energy consumers

Report

Outcome of review into whether conditions are in place for effective competition in domestic supply contracts

Publication date: 7 August 2020

Contact: Maureen Paul, Interim Chief Economic Adviser
Martin Campbell, Interim Head of Analytical Strategy and Development
Sean Slack, Senior Economist

Team: Office for Research and Economics

Tel: 020 7901 7000

Email: EffectiveCompetition@ofgem.gov.uk

This report sets out the outcome of our review into whether conditions are in place for effective competition in domestic supply contracts. It includes our recommendation on whether the default tariff cap should remain in place for 2021. Our analysis follows the assessment framework that we published in October 2019.

Contents

Foreword

Last October, we published our framework on how we will assess whether conditions are in place for effective competition in the domestic retail market. This included the three conditions that we expect to be in place if we are to recommend lifting the price cap: that there are structural changes facilitating competition; the competitive process is functioning well; and the market outcomes are fair for consumers. We recognise that it will take time for competition to become effective and we said that we will not recommend lifting the cap until we are confident that these conditions are in place 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.

A lot has happened since October, not least the global Covid-19 pandemic that has affected us all. Many households have suffered reductions in income and massive disruption to their day-to-day lives, while energy suppliers have had to operate in a very different environment and continue to face financial challenges of their own.

We are very much alive to these issues, and as an organisation have spent a great deal of time understanding the implications of Covid-19 for the functioning of the energy market and how we can best support consumers. While the pandemic has not ultimately changed or driven the conclusions we have reached in this review, it has decelerated and in some cases halted progress in meeting the conditions we set out.

Overall, our review recognises that the market is working well in many ways, for example through increases in switching rates and overall engagement driving stronger competition between suppliers to win and retain engaged consumers. However, more than half of energy consumers are still on default tariffs and the evidence does not show that they would, in the absence of the price cap, continue to be treated fairly.

This, in combination with rest of the analysis set out in our review, has informed our decision to recommend to the Secretary of State that the price cap remain in place for 2021. As we all navigate this turbulent period, this will ensure that consumers are treated fairly as the market continues to develop in the positive directions that we have seen in this review.

Maureen Paul
Interim Chief Economic Adviser, Ofgem

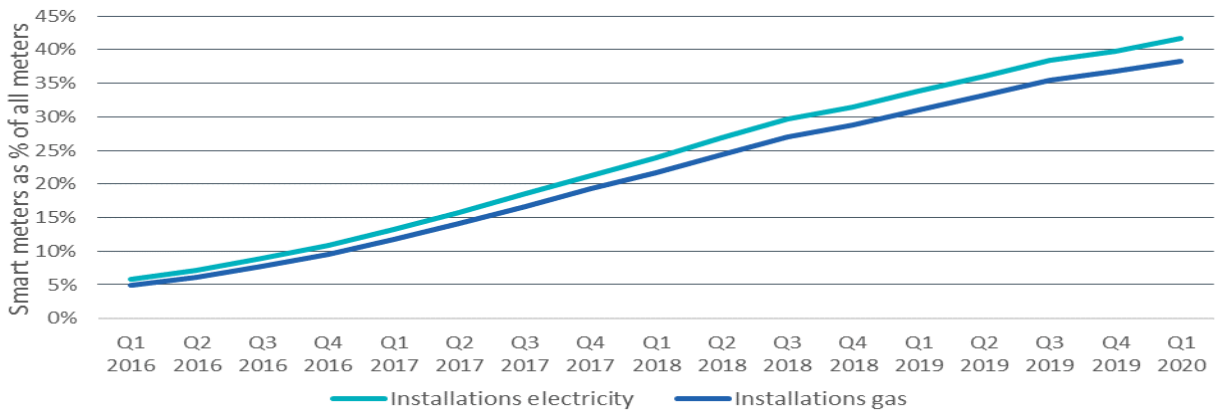
Executive Summary

This is a report on the outcome of our review into whether conditions are in place for effective competition in the domestic retail energy market. We have concluded that these conditions are not yet in place and recommend retaining the price cap on default and standard variable tariffs (the "default tariff cap") for 2021. This report and the analysis underpinning it meets our requirements under Section 7 of the Domestic Gas and Electricity (Tariff Cap) Act 2018.

In October last year, we published our decision framework for carrying out this review. The framework set out three conditions that would need to be in place for there to be effective competition. Having applied this framework, our conclusion on each condition is as follows:

- **Condition 1: Structural changes from the government, Ofgem and the wider market are facilitating competition.**
  Some important progress has been made, such as the modification of licensing requirements to ensure that new entrants are well prepared to meet their commitments to consumers who switch to them, while retaining incentives for supplier entry and innovation. The market is also providing innovative ways for consumers to engage directly or indirectly, for example through price comparison websites and automatic switching services. However, progress with other changes, such as the installation of smart meters (see Figure 1), have been slower than expected and further limited by the Covid-19 pandemic. Finally, changes in the coming years – such as our Faster and More Reliable Switching Programme – are intended to enable greater consumer engagement, confidence and trust in the market and will help with progress in meeting this condition.
  Overall, we conclude that Condition 1 is not yet met.

Figure 1: Progress with installing smart meters

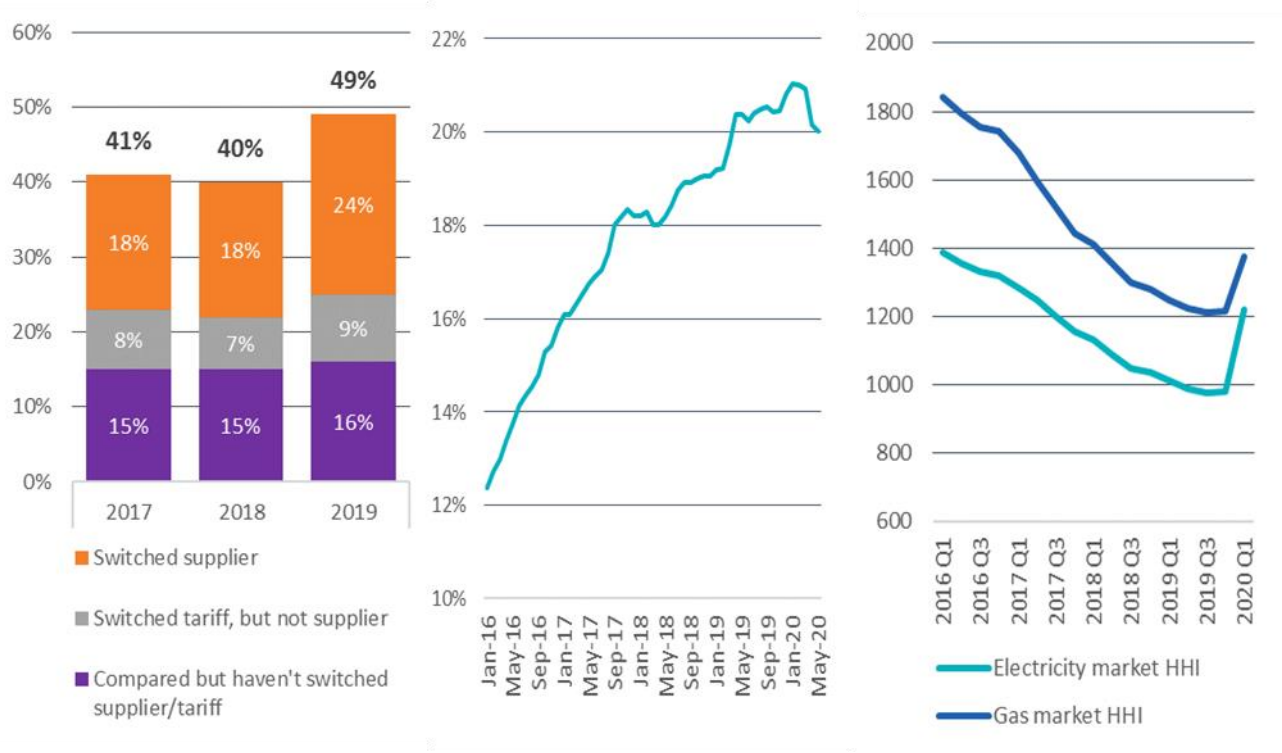


Source: See Figure 5 in main text.

- **Condition 2: The competitive process should be expected to work well in the absence of the price cap.**
  Since the time of the Competition and Market Authority's Energy Market Investigation in 2016, the retail market has become more competitive. Consumer engagement has overall increased and we have seen record high rates of switching leading up to Covid-19: this trend has been driving stronger rivalry between suppliers, with medium-sized suppliers in particular winning and retaining customers from the large incumbents (see Figure 2).

Figure 2: Consumer engagement has increased and the market is less concentrated

(a) Consumer Engagement (b) Switching rate (electricity) (c) Market concentration



Source: See Figure 7, Figure 8 and Figure 10 in the main text.

However:

- We remain concerned about the size of the disengaged customer segment, who are more likely to be lower income, and the competitive dynamics that may result if the default tariff cap were lifted. In particular, it is not clear that engagement levels across default tariff customers would be sufficient to constrain the price setting of default tariffs, in the absence of the cap. While the proportion of households on default tariffs for electricity has fallen by 5 percentage points since 2016, it remains

the case that the majority of households are on these tariffs.[1]

- The larger suppliers are pursuing efficiency programmes to bring costs closer in line with the efficient benchmark of the default tariff cap. However, these programmes will take time to bear fruit and deliver lasting productivity gains.

- The Covid-19 pandemic has placed financial strain on both consumers and suppliers. As the situation evolves, the scale of these issues will become clearer and we are monitoring closely how this may affect market structure and competition. We will also monitor how switching and consumer engagement more generally evolve, given the dip in switching rates since the pandemic.

Overall, we conclude that Condition 2 is not yet met.

- **Condition 3: The competitive process should deliver fair outcomes for consumers.**
  We expected that the default tariff cap would narrow price differentials between default tariffs and fixed tariffs, because it lowers the price of default tariffs. However, price differentials have not fallen, but may still be lower than if the cap were not in place (see Figure 3). There is therefore significant uncertainty on how prices and differentials will evolve post-cap, with little evidence to suggest that households on default tariffs would continue to pay a fair price if the cap were lifted. This, in combination with increased pressure on household budgets due to Covid-19, increases the risk of lifting the cap.

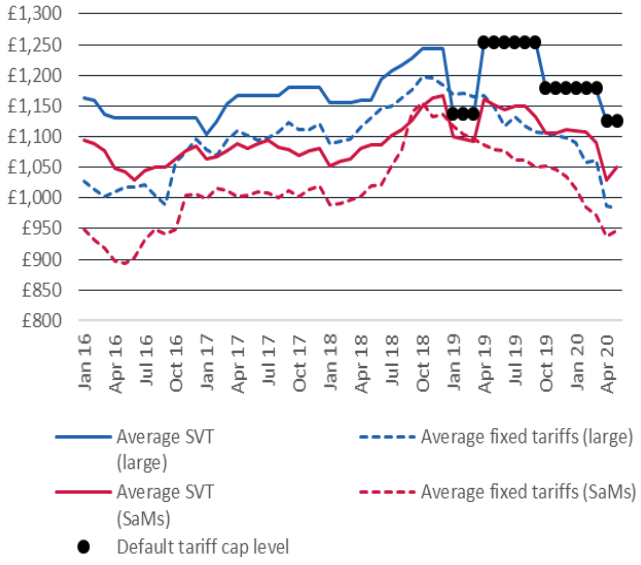
  There is significant variation in quality of service across suppliers, with customer satisfaction highest among medium sized suppliers, and rising complaints among customers of smaller suppliers. This suggests that some of the smaller suppliers may not be adequately prepared and resourced to meet their commitments, and as this is addressed there may be changes to market structure. Overall, it is not clear that customer service is improving.

  Overall, we conclude that Condition 3 is not yet met.

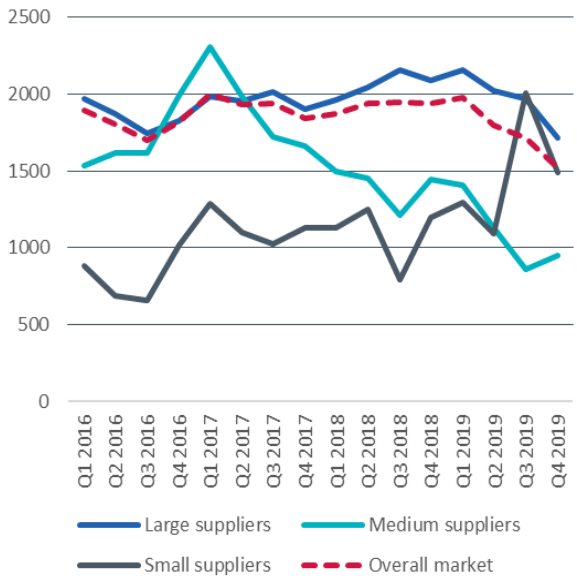
[1] As of October 2019, 52% of all electricity customers were on default tariffs.

Figure 3: Tariff prices and customer complaints

(a) Prices at typical consumption (2019 prices)



(b) Complaints per 100,000 customers



Source: See Figure 18 and Figure 22 in the main text.

Based on our conclusion that these conditions for effective competition are not in place, we recommend that the default tariff cap remain for 2021. This will ensure that customers are protected while the functioning of the retail energy market continues to improve.

1. Introduction

Context and related publications

1.1. The Domestic Gas and Electricity (Tariff Cap) Act 2018, hereafter the "Tariff Cap Act",[2] required us to put a price cap on default and standard variable tariffs. This was due to widespread concern that the market was not working as well as it should for consumers on these tariffs, who are typically less engaged with the market and the products it offers. In particular, there was concern that these consumers were being overcharged for their energy supply.[3]

1.2. We introduced the default tariff cap in January 2019. It is a temporary measure that places a limit on the price suppliers can charge for default and standard variable tariffs.[4] The default tariff cap is in place until the end of 2020, but can be extended for each year that the Secretary of State concludes that the conditions are not yet in place for effective competition in the domestic retail market, up to the end of 2023 at the latest. Section 7 of the Tariff Cap Act requires us to undertake a review of whether the conditions are in place. We must publish a report on the outcome of this review, including our recommendation on whether the default tariff cap should remain in place for 2021, by 31 August 2020. The Secretary of State will consider it and make a decision by 31 October 2020. If the default tariff cap remains in place for 2021, the same process will be repeated again in 2021 (similarly for 2022).

1.3. This report is the outcome of our review into whether conditions are in place for effective competition in the domestic retail market: it meets the requirements of the Tariff Cap Act set out above. The review that we have undertaken follows the analytical decision framework that we developed, through consultation, in 2019.[5]

[2] See Domestic Gas and Electricity (Tariff Cap) Act 2018.
[3] For example, see para 160 of CMA (2016), "Energy market investigation: Final report". This overcharging may be due to suppliers operating inefficiently and passing-through these inefficient costs to default tariff customers, or setting excessive prices.
[4] It is a cap on prices, not energy bills – which depend on the level of energy consumption.
[5] See Ofgem (2019) "Decision – Framework for assessing whether conditions are in place for effective competition in domestic supply contracts".

Overview of our decision framework

1.4. We developed an assessment framework for meeting the requirements under Section 7 of the Tariff Cap Act. As illustrated in Figure 4 below, the framework has four key components: a definition of effective competition[6] and three conditions for effective competition. While the conditions may be satisfied individually to differing degrees, we will assess whether they have been met overall. [7]

Figure 4: Overview of the conditions for effective competition

Definition of effective competition

- 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.

The Conditions for effective competition

Condition 1: Structural changes are facilitating competition.
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.

Condition 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.

Condition 3: Fair outcomes for consumers.
The competitive process should be expected to deliver fair outcomes for consumers in terms of what matters to them. For example, this includes not being overcharged due to prices being set high for excessive profits and/or due to inefficient costs being passed on.

[6] The Tariff Cap Act does not define effective competition, nor is there a generally accepted definition in relevant policy frameworks or academic literature. For our decision framework, we therefore developed a definition. 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).
[7] See pages 16 and 19 of Ofgem (2019) "Decision – Framework for assessing whether conditions are in place for effective competition in domestic supply contracts".

Covid-19 and its implications for this review

1.5. In our analysis, we have inevitably had to take into account the implications that the Covid-19 pandemic has had and may continue to have on how well the domestic retail market is working. While unprecedented levels of state support have been put in place to help protect the incomes of households,[8] the income shock that many households have experienced means that their energy bills as a proportion of income will have risen, giving rise to affordability concerns. Spending more time at home may have also led many households to consume more energy. The financial position of suppliers has also been tested during this period, both through the ability of consumers to pay their bills and through changes in demand.

1.6. In conducting our review, we have sought to identify the different channels through which the Covid-19 pandemic may impact progress against the conditions that we have set out, using the evidence available to us. While some of the more immediate impacts are clear, such as social distancing measures affecting progress with installing smart meters, the scale of other issues such as energy affordability is evolving and subject to uncertainty depending on how the overall economy evolves.

1.7. While Covid-19 has not helped progress in meeting the three conditions we set out, it has neither changed nor driven the outcome of this assessment: that conditions are not yet in place for effective competition.

Details on the assessment

1.8. The assessment presents data across the period 2016-2020, unless otherwise stated, and draws on the most contemporary data available at the time of the analysis. All price data is presented in real terms, in 2019 prices.

1.9. When referring to the group of large suppliers, we mean the historic large six (British Gas, SSE, E.ON, EDF, Scottish Power and npower) up to January 2020, but thereafter British Gas, OVO, E.ON, EDF and Scottish Power. This follows the

[8] For example, through more generous universal credit, the job retention scheme (JRS) and self-employed income support (SEIS),

acquisitions of SSE by OVO in January 2020 and npower by E.ON in September 2019 (customers began being transferred to E.ON in January 2020).

Structure of this report

1.10. The remainder of this report is structured as follows:

- In Chapter 2, we assess if structural changes introduced by the government, Ofgem and the wider market are improving the functioning of the competitive process (Condition 1 from our decision framework).

- In Chapter 3, we assess how the competitive process is working and can be expected to work post-cap (Condition 2 from our decision framework). This is composed of three parts: consumer behaviour and the ability of consumers to access, assess and act on information in the market; the structure of the market; and finally the performance of suppliers in terms of their efficiency and profitability.

- In Chapter 4, we assess whether the competitive process can be expected to generate fair outcomes for consumers, in terms of what matters to them (Condition 3 from our decision framework). This involves assessing the evolution of prices, price differentials and quality of service against the fairness principles that we set out in our decision framework.

Your feedback

1.11. We believe that feedback is an important part of good policy development. We are keen to receive your comments about this report, including any answers to:

1. Have we accurately described market developments?
2. Are the conclusions that we reach balanced?
3. Do you have any comments about the overall process of producing this report?
4. Do you have any comments about its tone and content?
5. Was it easy to read and understand?
6. Any further comments?
7. If you require a version of the document with accessible graphs (underlying data behind the graphs) please contact the below email address.

Please send any general feedback comments to EffectiveCompetition@ofgem.gov.uk.

2. Assessing condition 1: Structural changes should facilitate competition

Chapter summary

In this chapter, **we set out our view that Condition 1 is not yet met**. We find that:

- Some important progress has been made, including changes to licensing requirements to ensure that new entrants are well placed to meet their commitments.
- However, some changes, such as progress with the smart meter rollout, have been slower than expected and impacted by Covid-19.
- Finally, changes in the coming years – such as our Faster and More Reliable Switching Programme – should enable greater consumer engagement with the market and help with progress in meeting this condition.

2.1. Our first condition is that structural changes should facilitate competition. These structural changes include those from the government, Ofgem, and the wider market. Each of the structural changes that we consider has a bearing on how well competition works, for example through allowing consumers to better understand their energy use and make informed choices, to be able to act on these choices by switching swiftly and reliably, as well as ensuring suppliers are financially prepared to meet their commitments.

Structural changes from the government: Smart meter rollout

Progress with installing smart meters has been slower than expected

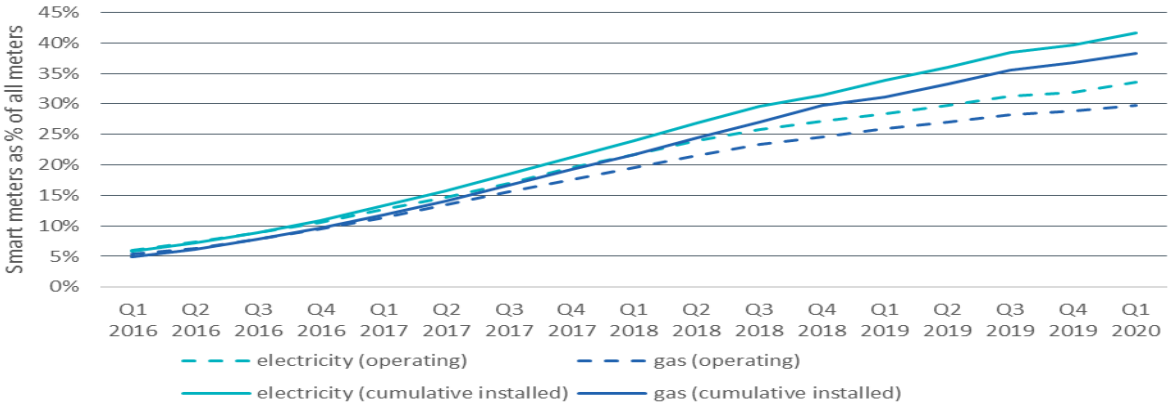
2.2. As part of our assessment, we are required by the Tariff Cap Act to consider the progress of the smart meter rollout for domestic consumers.[9] Smart meters should facilitate the competitive process by giving consumers both real-time and historic information on their energy use, allowing them to make more informed choices on the tariffs and suppliers that best meet their energy needs. This information will also

[9] See section 7 (2) of the Domestic Gas and Electricity (Tariff Cap) Act 2018.

help remove many of the specific engagement barriers faced by customers (such as understanding energy use and how much it costs), and make meter type less of a driver of variations in costs to serve (for example, prepayment and credit customers will no longer need different meters).

2.3. Figure 5 illustrates the progress with the supplier-led smart meter rollout. It distinguishes between the percentage of all domestic meters that have been installed as smart meters and the percentage that are operating in smart mode: it is the latter that benefits consumers most by giving them real time information on their accurate energy bills and access to a wider range of tariffs.[10] As of Q1 2020, over 20 million smart meters have been installed in households (39% of domestic meters), with almost 16 million of these meters operating in smart mode[11] (32% of all electricity meters and 29% of all gas meters were operating in smart mode).[12] [13]

Figure 5: Progress with the smart meter rollout



Note: Installation and operation figures are for large suppliers, defined in BEIS quarterly statistics as supplying "either gas or electricity to at least 250,000 domestic or non-domestic metering points".
Source: BEIS (2020) "Smart Meters Statistics, Quarter 1 2020, Great Britain".

[10] If a smart meter is not operating in smart mode (ie, can communicate externally), it can still provide a household with consumption information. However, energy costs may not be accurate as this depends on the meter having up-to-date tariff price information.
[11] BEIS (2020) Smart Meter Statistics, Q1 2020, Great Britain.
[12] The figures are slightly higher for meters operated by large suppliers (over 250,000 customers), at 34% and 30% for electricity and gas, respectively.
[13] At the end of 2019, the proportion of functioning smart meters that operate in prepayment mode (19%) was slightly higher than the corresponding proportion of all domestic meters that are prepayment (15%). Smart prepayment meters have their own specific advantages, such as allowing consumers to top-up remotely instead of visiting a top-up terminal. The meter will also display the amount of remaining credit, which reduces the risk that the customer will unknowingly run out.

2.4. To date, the pace of the rollout has been slower than expected. As the existing obligation on suppliers to take "All Reasonable Steps" (ARS) to install smart meters expires on 31 December 2020, BEIS consulted[14] on a post 2020 regulatory framework to ensure that investment in the rollout does not slow and has now published its response.[15] The ARS obligation will be extended to 30 June 2021 and, following this, a four-year framework involving annual installation targets for suppliers will be implemented.

2.5. First generation SMETS1 meters can lose smart functionality when customers switch to a new supplier, and this is likely to account for most of the installed smart meters that are not operating in smart mode. These SMETS1 meters are expected to regain smart functionality once they are enrolled with the Data and Communications Company (DCC): this is expected to be completed by the end of 2021, with enrolment of currently dormant meters prioritised. Around 662,000 SMETS1 meters have been enrolled to date.[16] In July 2020, the DCC reported that 4.6 million second generation (SMETS2) meters were connected to the network. By adding those SMETS2 meters to the enrolled SMETS1 meters, around 5.3 million smart meters are connected to the DCC and so should always maintain their smart functionality when a consumer switches supplier, which from a competition perspective helps minimise barriers to switching for these households.[17]

The Covid-19 pandemic has impacted smart meter installations

2.6. Following government guidance regarding Covid-19,[18] suppliers suspended non-emergency meter installations in late March 2020 while continuing to prioritise emergencies and assisting vulnerable customers. Non-emergency smart installs have gradually resumed since the end of May, in accordance with updated government guidance and the gradual easing of restrictions across Great Britain. Whilst it may take a while to return to pre-Covid 19 installation levels, energy suppliers are now

[14] BEIS (2019) "Delivering a smart system: Consultation on a Smart Meter Policy Framework post 2020".
[15] BEIS (2020) "Delivering a smart system: Response to a Consultation on a Smart Meter Policy Framework post 2020".
[16] Data available on the DCC web page.
[17] Outstanding SMETS1 meters that are not enrolled with the DCC may lose their smart functionality after a switch of supplier.
[18] https://www.gov.uk/government/publications/full-guidance-on-staying-at-home-and-away-from-others/full-guidance-on-staying-at-home-and-away-from-others#going-to-work.

installing smart meters at volume whilst continuing to have the safety, health and wellbeing of their customers and staff as their number one priority.

Structural changes led by Ofgem

2.7. As set out in our Forward Work Programme 2019-21,[19] we are implementing a number of structural changes that aim to improve the functioning of the market, delivering value for money for consumers and improving consumer outcomes in general. Each of the changes that we discuss will help encourage consumers to engage with the market, in turn driving rivalry across suppliers to win and retain these consumers.

Half-hourly settlement will help empower consumers to engage with the retail market

2.8. Currently, most consumers are settled on a 'non-half-hourly' basis using estimates of when they use electricity, based on a profile of the average consumer usage and their own meter reads (taken over weeks and months). As smart meters can record energy consumption every half-hour, they enable half-hourly settlement, allowing suppliers to offer innovations such as time-of-use tariffs.

2.9. We have already introduced reforms to facilitate half-hourly settlement on an elective basis for domestic consumers. Our work on market-wide half-hourly settlement builds on this, ensuring that suppliers face the true costs of serving all of their customers, incentivising the development of new tariffs and services which reward customers for shifting their consumption to times when electricity is cheaper to generate and transport.[20] This will improve the efficiency, and therefore competitiveness, of domestic electricity supply.[21] It has the potential to significantly reduce costs for households that can shift their consumption to different times of the day, or households whose consumption patterns already align with the times of the day when energy is cheaper.[22] Moreover, we would expect that the increased range

[19] See Ofgem (2019) Forward Work Programme 2019-2021.
[20] See Ofgem (2020) Electricity retail market-wide half-hourly settlement: consultation.
[21] We consider that our work on Market-wide half-hourly settlement effectively remedies the adverse effect on competition identified in para. 187 of CMA (2016), "Energy market investigation: Final report".
[22] Moreover, we expect significant system benefits from the resulting reduction in aggregated peak demand. For example, see Ofgem (2020) Impact Assessment: Electricity retail market-wide half-hourly settlement: draft IA.

of products – and innovative ways that market providers find to communicate household energy use – will help empower consumers to engage with the retail market. It is important that suppliers offering more complex tariff choices provide consumers with sufficient information – through timely, clear and simple messaging – to make an informed choice about the tariff that is best for them.[23] Our final decision on market-wide half-hourly settlement is planned for spring 2021.

Our Faster and More Reliable Switching Programme will improve the switching experience

2.10. A reliable, quick and efficient switching process is a fundamental building block of a well-functioning competitive market that provides good outcomes for consumers. It helps consumers engage with the market with the confidence that the benefits of switching to a better deal can be realised quickly and will not cause disruption to their day-to-day lives through things going wrong. This in turn facilitates greater competition between suppliers to win and retain these consumers.

2.11. However, current switching arrangements in the market are not working as well as they could. They can cost consumers time and money and put them off switching in future.[24] Our Faster and More Reliable Switching Programme aims to facilitate next day switching and is expected to go live in 2022.[25] The current average switching time for electricity is 16 days while gas averages at 18 days to complete a switch.[26]

Guaranteed Standards of Performance protect consumers if switching goes wrong

2.12. If something does go wrong in the switching process, consumers should have the confidence that they will be compensated for this. Between May 2019 and May 2020 we launched seven new Guaranteed Standards of Performance (GSOP), which require suppliers to automatically pay £30 in compensation to the affected consumer when they do not meet the standards set out in the GSOP.[27] This benefits

[23] See Ofgem (2020) Potential consumer impacts following the implementation of Market-Wide Half-Hourly Settlement.
[24] See Ofgem (2018) Impact Assessment – Delivering Faster and More Reliable Switching: decision on new switching arrangements.
[25] No earlier than January 2022.
[26] Ofgem analysis of electricity distribution network operator (DNO) and Xoserve (gas) data. Information correct as of: January 2020.
[27] Three of the Guaranteed Standards introduced in May 2019 related to the rectification of erroneous switches, and one requiring suppliers to return customer credit balances no more than 10 working days after issuing a final bill. The three new standards introduced in May 2020 require suppliers to

competition through incentivising suppliers to improve their switching performance, in turn incentivising consumers to engage with the market through lowering the risk (and perceived risk) that something could go wrong in the switching process.

2.13. In light of Covid-19, we recognised that suppliers were under pressure to redeploy resource to meet the most pressing customer needs. We therefore introduced a framework for regulatory flexibility[28] that encouraged suppliers to uphold GSOPs where possible, but permitted suppliers not to pay compensation when a problem in the switching process has been caused by exceptional impacts of Covid-19 that are beyond the supplier's control. From 1 July 2020, we decided that the impacts of Covid-19 on supplier operations would no longer amount to exceptional circumstance in the majority of cases.[29]

Licensing reforms mean new entrants must demonstrate they can meet their commitments

2.14. The entry of new suppliers has brought benefits to consumers through increased price competition, innovative offerings, and pressure on incumbent suppliers to improve their offer. However, we have also seen an increase in supplier failures and instances of inadequate customer service, as some suppliers are insufficiently prepared to grow and meet their commitments. For example, some suppliers set very low prices to win customers, but their pricing strategy may be unsustainable and distort competition on prices. Supplier failure may reduce consumer confidence and trust in the market, and thus their incentive to switch to more competitive offerings on the market.

2.15. In 2018, we launched our Supplier Licensing Review (SLR),[30] to ensure that appropriate protections are put in place to guard against poor customer service and financial instability. The package of reforms covers three areas: conditions for suppliers entering the market, ongoing requirements and monitoring for those

complete a switch no later than 15 working days, to issue final bills within six weeks and to ensure consumers are not erroneously switched at all.

[28] Ofgem (2020) - Impact of COVID-19 on retail energy supply companies - an enabling framework for regulatory flexibility.

[29] Ofgem (2020) Impact of COVID-19 on retail energy supply companies - regulatory expectations from 1 July 2020.

[30] https://www.ofgem.gov.uk/publications-and-updates/supplier-licensing-review

already operating in the market and arrangements for managing supplier failure and market exit.

2.16. The first stage of the review, regarding reforms to market entry requirements, came into effect in July 2019.[31] Any prudent, well-prepared entrant should be able to demonstrate to us that they have appropriate resources to enter the market, understand their regulatory obligations, and are fit and proper to hold a licence.

2.17. We consider that these new entry requirements support effective competition through reducing consumers' exposure to the risk of underprepared market entrants, while maintaining incentives for the entry of new suppliers with potentially innovative business models. The competitive process will benefit from consumers having greater confidence that they can switch to new suppliers with less concern that they will fail or offer low quality service. While market exit is part of the normal competitive process, these changes should also mitigate the risks of supplier failure due to unpreparedness, and in turn reduce the burden on consumers and the wider market that arises when significant costs of failure are mutualised.[32]

Future SLR reforms help provide confidence that pricing strategies are sustainable

2.18. In choosing to switch to a given supplier, consumers may also need the confidence that the supplier is operating on a financially viable basis, particularly if they are setting very low prices to win and retain customers. Competition may be distorted by unsustainable pricing strategies and the costs that are left behind when a supplier with inadequate risk management fails, as some of these costs may need to be mutualised across suppliers and ultimately consumers. The next phase of the SLR therefore focuses on ongoing requirements and exit arrangements for those already operating in the market. The current proposals[33] include the introduction of a Financial Responsibility Principle, which aims to minimise the extent of cost mutualisation in the event of a supplier failure. This requires that suppliers, at a minimum, have plans in place to meet their financial obligations, effective processes

[31] See Ofgem (2019) Decision – Supplier Licensing Review: Final proposals on new entry requirements.
[32] This can happen where the failed supplier had unpaid commitments under government schemes (such as the Renewables Obligation) or significant customer credit balance liabilities that the appointed SoLR makes a claim for under the SoLR levy.
[33] See Ofgem (2020) Statutory Consultation – Supplier Licensing Review: Ongoing requirements and exit arrangements.

for setting direct debit levels, sustainable pricing strategies and arrangements that would reduce the need for costs to be mutualised. These reforms progressed to statutory consultation in June 2020.

Wider market developments

The market increasingly provides ways to facilitate engagement

2.19. In 2018 our consumer research showed that 54% of those who switched or compared tariffs or supplier used a price comparison website to do so (up from 45% in 2017). In 2019, we modified our analysis to incorporate emerging 'auto-scanning' and 'automatic switching' services: 49% of consumers used a price comparison service to find their energy deal, a further 8% used an auto-scanning service that notified them of new deals and 2% used an automatic switching service. In total, 59% of consumers made use of a third party intermediary to find their energy deal.[34]

2.20. Over the last 3 years, there has been an increase in the number of intermediaries offering automatic switching services. Consumers who enrol are automatically switched to the best energy tariff that the service can identify, given a consumer's stated preferences. Approximately 300,000[35] consumers were making use of these services in 2019.

Overall conclusion: Condition 1 is not yet met.

2.21. Important progress has been made on structural changes to facilitate competition. This includes modifications to licensing requirements to ensure that new suppliers are well prepared to meet their commitments while retaining incentives for market entry and innovation; and the market providing innovative ways for consumers to engage. However, progress with some other structural changes has been slower than expected and affected by the Covid-19 pandemic, such as progress with the installation of smart meters. Finally, some other structural changes that will further facilitate the competitive process will be implemented over the course of the coming

[34] See Ofgem, GFK (2018) Consumer Engagement in the Energy Market 2018; and Ofgem, Ipsos (2019) Ofgem Consumer Survey 2019: Tracking data and insights into future energy solutions.
[35] Citizens Advice (2020) "Stuck in the middle: How to improve protections for people using energy third party intermediaries".

years. This includes our Faster and More Reliable Switching Programme, which will give consumers the confidence that when they engage with the market their choices can be actioned quickly and without things going wrong. There are also some further changes to licensing requirements around ongoing requirements and supplier exit, to drive up service standards and minimise the disruption of exits on consumers and potential distortionary impact on the market.

3. Assessing condition 2: well-functioning competitive process

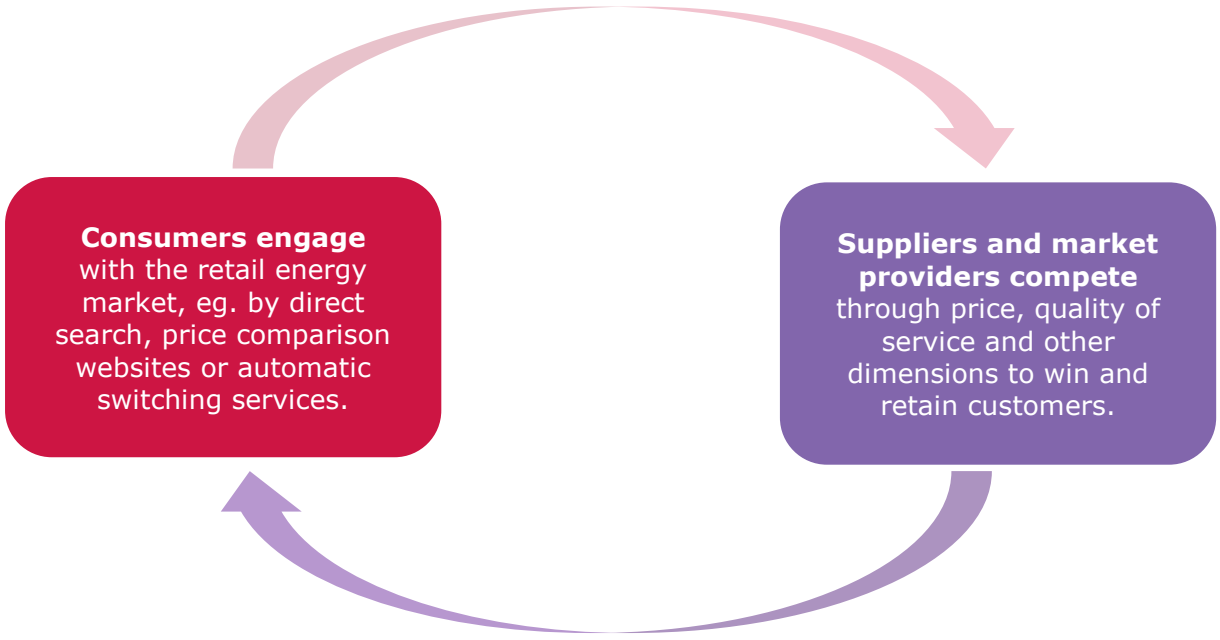
Chapter summary

In this chapter**, we set out our view that Condition 2 is not yet met.** We find that:

- The retail market has become more competitive since 2016, with increased consumer engagement and record high switching rates leading up to Covid-19 driving stronger competition, in particular through medium-sized suppliers attracting customers away from the large suppliers.
- However, we remain concerned about the size of the disengaged customer segment – the majority of consumers are on default tariffs – and the competitive dynamics that may lead these consumers to be overcharged if the cap was lifted.

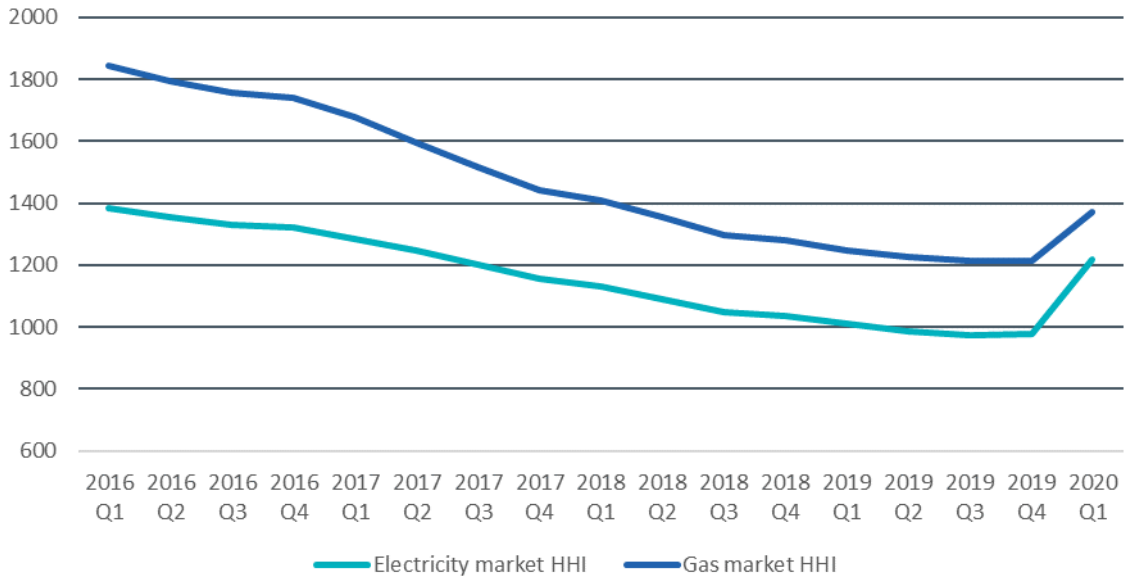
3.1. When the competitive process is working well, consumers are able to access, assess and act on information available to them. When sufficient numbers of consumers actively participate in the market, this incentivises market providers to become more efficient, to improve their production technologies and to bring innovative business models and products to the market. This virtuous circle, where consumer engagement drives rivalry across market providers, is illustrated in Figure 6.

Figure 6: Competition as a virtuous circle



3.2. Over the past seven years, the domestic retail energy market has become less concentrated, across both electricity and gas (see Figure 7).[36] This acts to improve consumer outcomes because larger suppliers have less market power when setting prices and the quality of service they provide. The uptick in market concentration between Q4 2019 and Q1 2020 is due to the acquisitions of SSE by OVO and npower by E.ON, as approved by the CMA. The implications of this are discussed in more detail in para 3.21, but we do not expect this to result in a substantial lessening of competition.

Figure 7: Market concentration – Herfindahl-Hirschman Index (HHI)



Source: Ofgem's analysis of Distribution Network Operators data.

3.3. There are three parts to our assessment of the competitive process:[37]

[36] The Herfindahl–Hirschman Index (HHI) measures market concentration by summing the squares of the market share of each firm. It provides insights into how competitive a market is. The closer a market is to being a monopoly, the higher will be the measure of concentration. The CMA typically regards markets with HHI below 1,000 as unconcentrated, markets with HHI between 1000 and 2000 as concentrated, and markets with HHI above 2,000 as highly concentrated. See CMA's latest market investigation guidelines.

The HHI for the electricity market was below 1,000 across Q2-Q4 2019, but rose to 1,218 in Q1 2020 following the acquisitions of SSE by OVO and npower by E.ON. The gas retail market remains more concentrated than electricity, with a HHI value of 1,374 in Q1 2020.

[37] Ofgem (2019, p.30) "Decision – Framework for assessing whether conditions are in place for

- *Consumer behaviour*: consumers should be able to readily 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.

- *Market structure and dynamics:* 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).

- *Supplier performance*: There should be sufficient commercial opportunity for any well-prepared prospective supplier to want to enter the market.

Consumer behaviour

3.4. A consumer engages with the energy market when they take steps to identify the best deals for them, and act on this information in deciding whether to switch tariff, supplier or remain with the status quo.[38] There are a range of different ways that consumers may engage, such as through direct search, price comparison websites or by proxy through automatic switching services.

3.5. Consumer engagement, in its various forms, is central to driving competition between market providers to win and retain customers. The higher the level of consumer engagement, the more elastic the demand that suppliers face. This places a restraint on price-setting behaviour and incentivises good customer service.

effective competition in domestic supply contracts".

[38] See Ofgem (2019, p.12) Insights from Ofgem Consumer Engagement Trials: what works in increasing engagement in energy tariff choices, where we state that:
"By engagement, we mean a customer's ability and willingness to engage in their choice of energy supplier and tariff. We think of engagement as a spectrum, with some customers being very engaged, regularly shopping around for the best deal and potentially getting the latest energy saving kit for their homes, and others, at the other end, not ever thinking about it. A person can be engaged, for example by knowing the tariff options available to them but decide not to switch. Equally a person can switch without being fully engaged in the process, perhaps using an automated switching service. A key outcome of interest to Ofgem is that the customer can make an informed choice about their tariff."

Consumer engagement is increasing overall, but differs significantly across consumers

3.6. Figure 8 illustrates the significant increase in engagement between 2018 and 2019, where just under half of all consumers said that they engaged with the market in some way:

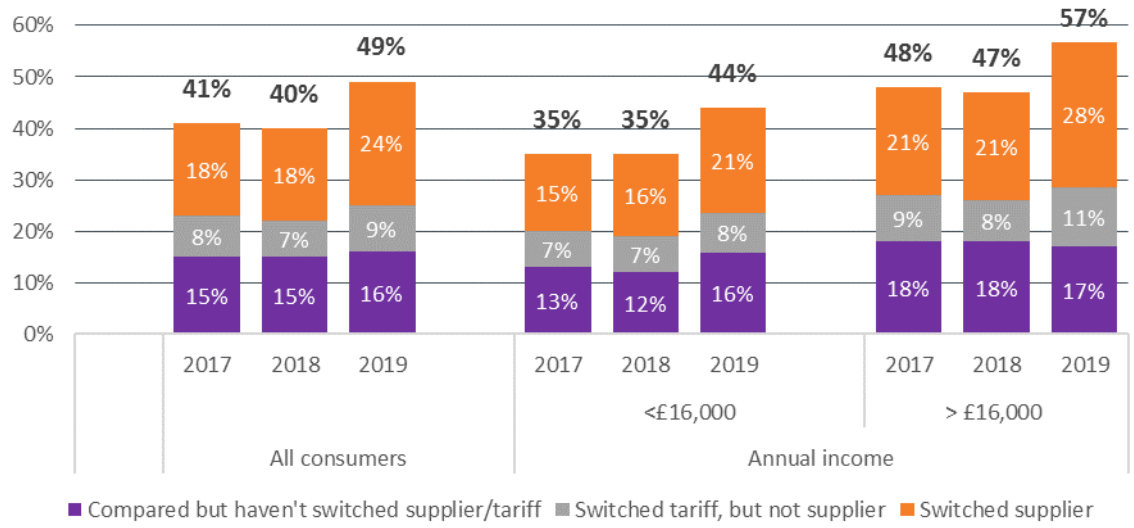
- This increase was largely driven by an increase in the proportion of consumers who switched supplier. [39]

- The increase in switching was predominantly from switchers who have switched tariff and/or supplier previously (see Figure 9). This implies there is a pool of consistently engaged consumers, who have realised the benefits of switching tariffs and continue to be incentivised to do so by the competitive offerings that suppliers are bringing to the market.

- While engagement increased across income groups, the level of engagement is positively correlated with gross income, suggesting that those on default tariffs may on average have lower income than those on fixed tariffs. [40] [41]

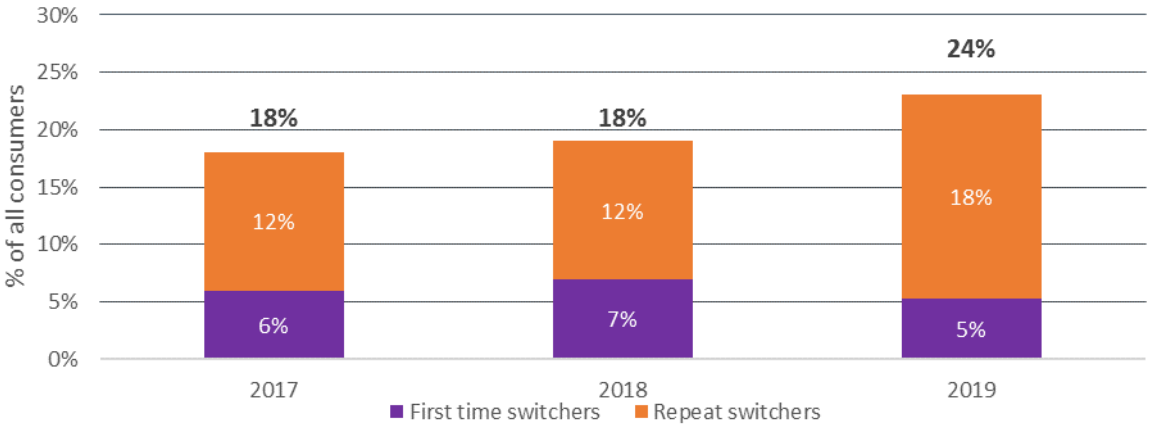
[39] The percentage of consumers that report switching supplier in the past year has increased by 10 percentage points since 2014, from 14% in 2014 to 24% in 2019.
[40] Protecting consumers in vulnerable situations is a key priority for Ofgem: consumers of low income fall into this group (see section 3A of the Electricity Act 1989).
[41] Engagement levels also vary by payment method, with direct debit customers the most engaged.

Figure 8: Consumer engagement, overall and by income, 2017 - 2019



Source: Ofgem Consumer Surveys 2017, 2018 and 2019.

Figure 9: Supplier switching - first time and repeat switchers, 2017-2019



Source: Ofgem Consumer Surveys 2017, 2018 and 2019.

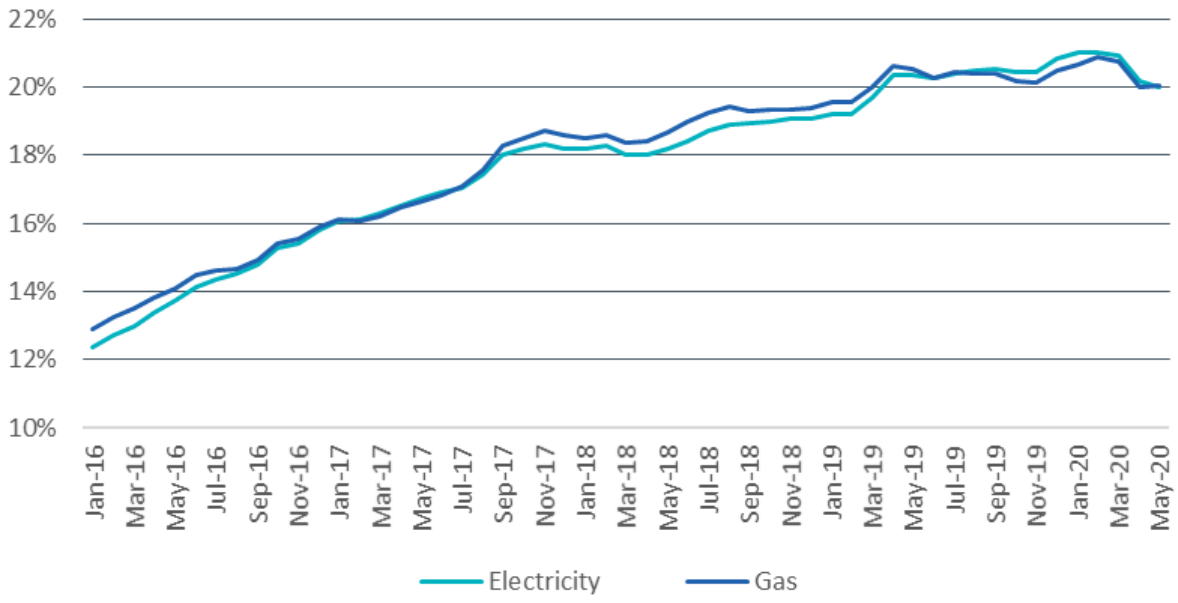
Switching has increased significantly, but the majority of consumers are on default tariffs

3.7. Average annual switching rates have almost doubled over the past six years, from 11% for both fuel types in 2014, to 21% and 20% for electricity and gas respectively in 2019. Figure 10 below illustrates this positive direction of travel through rolling average annual switching rates up to May 2020. For the 12 months up to March

2020, there were 6 million switches in electricity, and 4.9 million in gas. These values are higher than those observed in the 12 months up to March 2019, where there were 5.6 million switches in electricity and 4.7 million in gas. The values for the 12 months up to May 2020 were marginally lower for electricity and gas than for the 12 months up to May 2019. The reduction in switching activity in April and May is likely due to the Covid-19 pandemic and we will continue to monitor how switching and overall engagement evolve.

3.8. These switching rates are high compared with other utility sectors and retail energy markets around the world (for instance, Norway had the highest electricity switching rate in Europe in 2018, at 21%, while the State of Victoria in Australia reached 30% in 2017/18).[42]

Figure 10: Rolling average annual switching rate

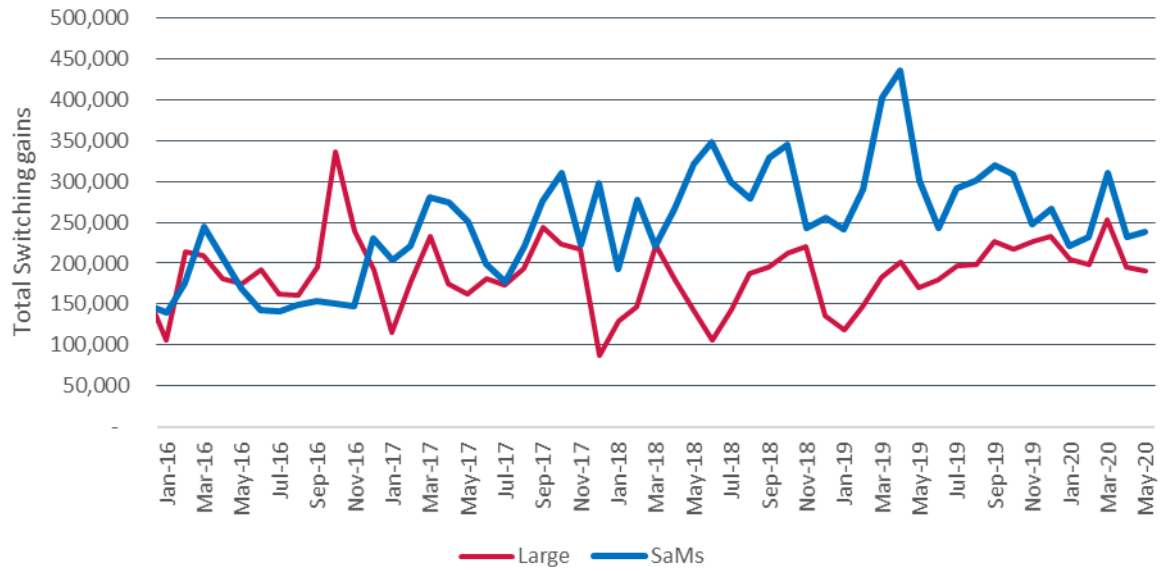


Note: The switching rates at each date are calculated as the ratio between the total number of switches during the previous twelve months and the average number of meter points during the same period.

Source: Ofgem analysis of data from electricity distribution network operators (DNOs) and Xoserve.

[42] See BEIS Consumer Green Paper, CEER Retail Market Monitoring Report 2018 and AER State of the Energy Market 2018

Figure 11: Switching gains for suppliers, electricity



Note: Large suppliers are British Gas, SSE, E.ON, EDF, Scottish Power and npower up to January 2020, but thereafter British Gas, OVO, E.ON, EDF and Scottish Power.
Source: Ofgem analysis of data from electricity distribution network operators (DNOs) and Xoserve.

3.9. Figure 11 illustrates that a significant driver of this increase in switching has been customers moving to and within the group of small and medium suppliers (SaMs).[43] Data on switching flows – where consumers are moving from and to – shows that over the course of 2019:

- *Between-group switches.* Large suppliers had a net loss of customers to small and medium suppliers, while the majority of customers who switched away from large suppliers went to medium-sized suppliers with between 200,000 and 1.8m customers.[44] This group of suppliers had net customer gains from all other types of suppliers in 2019.

- *Within-group switches*. There is significant competition within the group of large suppliers. The majority of customers who switched to a large supplier came from a different large supplier. This suggests that engaged customers with one of the large suppliers find the offerings of other large suppliers competitive – in terms

[43] Since September 2019, the absolute difference in switching gains has narrowed between large and other suppliers.
[44] Including Bulb, Octopus, Shell Energy, OVO, and Utilita.

of what matters to them (eg, established brand) – relative to other offerings on the market.

3.10. In our default tariff cap impact assessment, we estimated that switching under the cap could fall by up to 50%.[45] This was largely because we expected lower price differentials between default and fixed tariffs, which would reduce the financial incentive to switch. We also recognised that consumers might feel sufficiently protected under the cap and therefore perceive little benefit to switching.

3.11. As illustrated by the growth in switching rates, we have so far seen little evidence of these effects.[46] This might be because price differentials have not narrowed as we expected, remaining at relatively high levels[47] (see Chapter 4) - mainly driven by wholesale prices trends and more aggressive pricing strategies for fixed tariffs. Moreover, some of the increase in consumer engagement may have been prompted by the high level of media attention around the default tariff cap and the need for consumers to continue to look for the cheaper market deals.[48]

3.12. However, despite the increases in consumer switching and engagement more generally that we have seen, as of October 2019, 52% of all domestic electricity consumers were on default tariffs, with just over half of this group having been on a default tariff for over three years.[49] While this is 5 percentage points lower than in October 2016, it therefore remains the case that the majority of households are still on default tariffs.

The reliability of the switching process is a concern for consumers

3.13. In a well-functioning competitive process, consumers should be able to switch supplier swiftly and reliably. Supply licences require licensees to take all reasonable

[45] Using evidence from various sources and case studies. See Ofgem (2018, p.48) Decision – Default tariff cap – Overview document.
[46] We undertook some preliminary econometric analysis to help understand the drivers of switching rates, including price differentials and service quality, and the degree to which switching rates may have been impacted by the default tariff cap. Given the limited time-series of data available, the results were inconclusive. As more data becomes available, we may further develop this work.
[47] Price differentials may still be lower than if the default tariff cap were not in place.
[48] However, our Consumer Survey data from 2019 suggests that many consumers did not understand whether the default tariff cap applied to them.
[49] These figures do not include Bulb. This is because Bulb offers only one variable tariff which, while being an SVT, is priced competitively with fixed tariffs and is used to acquire customers.

steps to complete a transfer 21 days after the end of the 14-day cooling-off period (or after an earlier date during the cooling-off if agreed with the customer).

3.14. The proportion of erroneous transfers, where consumers are switched to suppliers against their wishes, has stayed broadly stable since 2014, fluctuating around 1% (between July 2018 and July 2019 there were around 130,000 erroneous gas and electricity transfers). The wrong meter point being switched has typically been the main cause. Inaccurate customer address data held across the industry remains the single largest reason for erroneous transfers. Inaccurate data also slows down the speed of the switching process. Both the accuracy of data and switching times will be markedly improved with our Faster and More Reliable Switching Programme.[50]

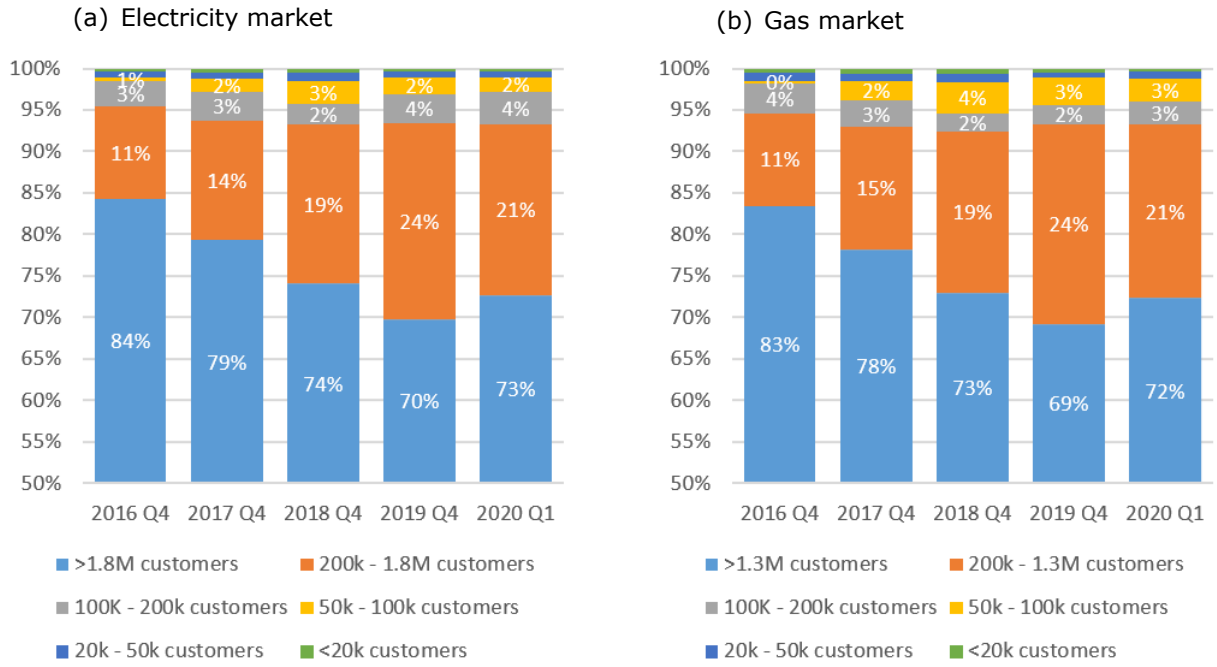
Market structure

Large suppliers have lost significant market share in recent years

3.15. The large incumbent suppliers are facing strong competition in the domestic energy market. Their collective market share has fallen significantly since 2016, down from 84% to around 70% in gas and electricity markets in Q4 2019 (see Figure 12). The slight uptick in the market share of large suppliers between Q4 2019 and Q1 2020 is due to OVO's acquisition of SSE. Over these four years, medium-sized suppliers with over 200,000 customers have more than doubled their collective market share, to around 21% in both gas and electricity markets. Suppliers with between 50,000 and 200,000 customers have also increased their market share, although to a lesser extent.

[50] The average switching time for electricity has been relatively stable at between 15 and 17 days, while gas is between 16 and 18 days.

Figure 12: Market share of energy suppliers by supplier size, 2016 - 2020



Note: The thresholds for the largest category of suppliers are based on the customer numbers for the historic large six suppliers and is different for gas and electricity (1.3m and 1.8m customers).[51]
Source: Ofgem's analysis of Distribution Network Operators and Xoserve data.

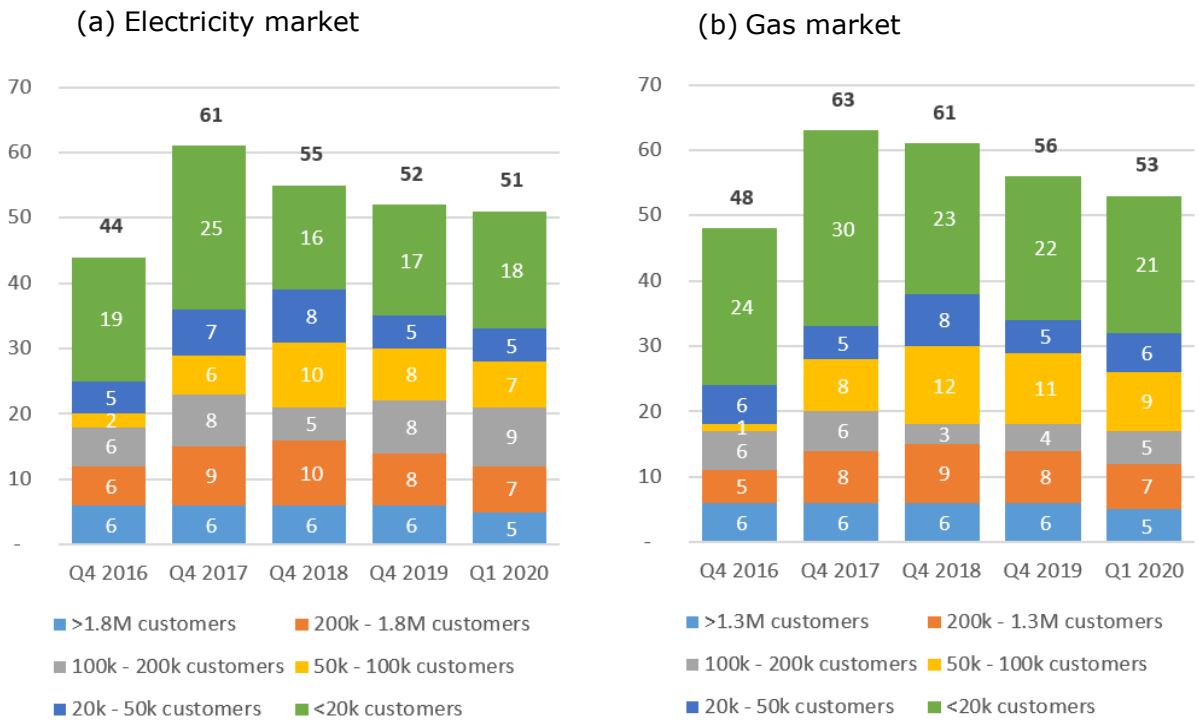
The number of energy suppliers grew up to 2018, but has fallen since then

3.16. Between 2016 and 2018, there was a net increase of around 15 suppliers in both electricity and gas markets (see Figure 13). New suppliers entered the market frequently during this period, with many having grown in size, as shown by the increase in the number of suppliers with between 20,000 and 200,000 customers up to mid-2018. The rising number of suppliers in these categories has contributed to their collective growth in market share, as show above in Figure 12.

3.17. However, this trend reversed in mid-2018, and there has been a net reduction in the number of suppliers in the electricity and gas markets up to Q1 2020.

[51] The methodology allows suppliers to move across categories as they grow over time. We have also tested fixing suppliers' categories over time and found broadly similar results.

Figure 13: Number of energy suppliers by supplier size, 2016-2020



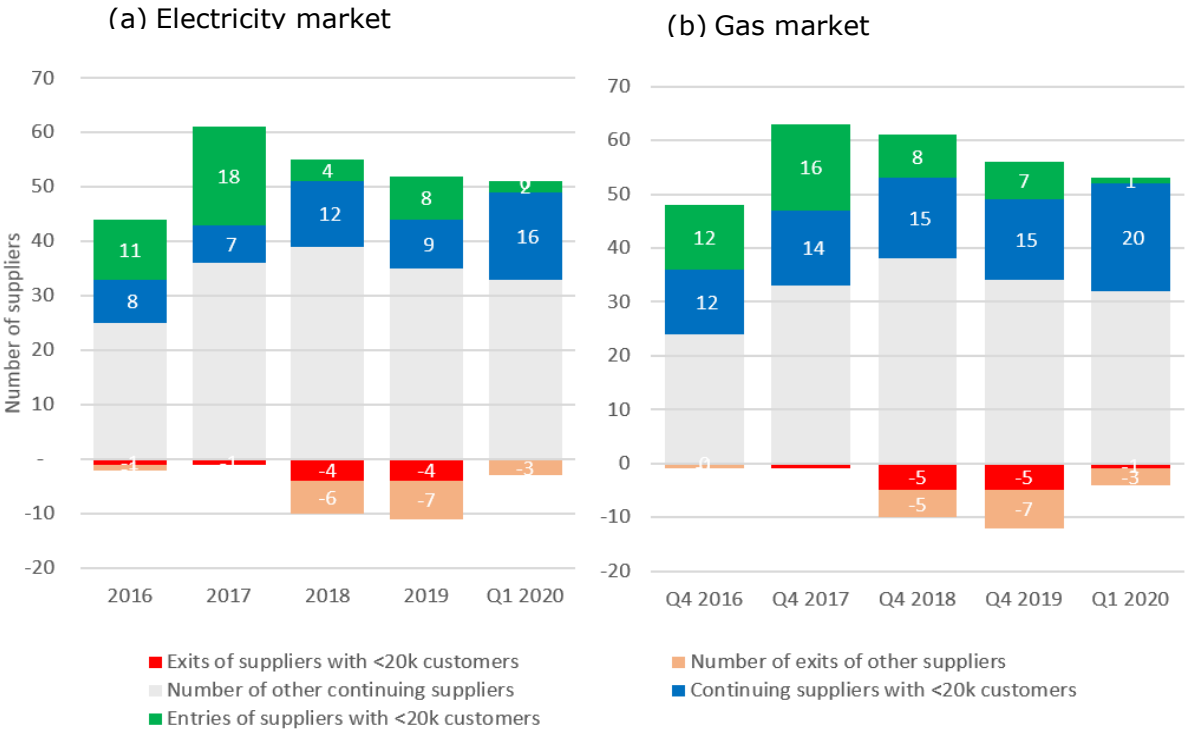
Note: Total supplier numbers are given in bold. The upper thresholds were chosen so that the largest groups only include the historic large six suppliers over the period.

Source: Ofgem's analysis of Distribution Network Operators and Xoserve data.

3.18. Over 20 suppliers have left the gas and electricity markets[52] since 2018, including a high proportion of suppliers with fewer than 20,000 customers (Figure 14). The majority of exiting suppliers have left through the Supplier of Last Resort (SoLR) process; however, these numbers also include direct acquisitions by other suppliers. The fall in the number of suppliers in Q1 2020 was entirely due to direct acquisitions.[53]

[52] Note that many of these suppliers operated in both gas and electricity markets, so their exit is counted as both an electricity and a gas market exit.
[53] The majority of direction acquisitions were for suppliers with over 20,000 customers.

Figure 14: Entry and exit of small suppliers, 2016-2020



Note: The 'remaining suppliers' category captures suppliers which were active in the previous quarter, and have fewer than 20,000 customers in this quarter. They may therefore include suppliers that were active and had more than 20,000 customers in the previous quarter. These numbers are not limited to supplier failure, but also include acquisitions.
Source: Ofgem's analysis of Distribution Network Operators and Xoserve data.

3.19. A range of factors contributed to supplier exits, including rising wholesale electricity prices from mid-2018, strong levels of price competition, and in some cases, withdrawal of parent company support, poor governance, or limited investment in customer service provision systems. The introduction of the default tariff cap from January 2019 is unlikely to have triggered these exits, as the suppliers who left the market had relatively few default tariff customers.[54]

3.20. Market exit is part of the normal competitive process and a retail market that exhibits effective competition would be expected to have some degree of supplier exit. However, suppliers that are insufficiently prepared for growth and adopt

[54] See Ofgem (2019, p.29) State of the energy market 2019 report.

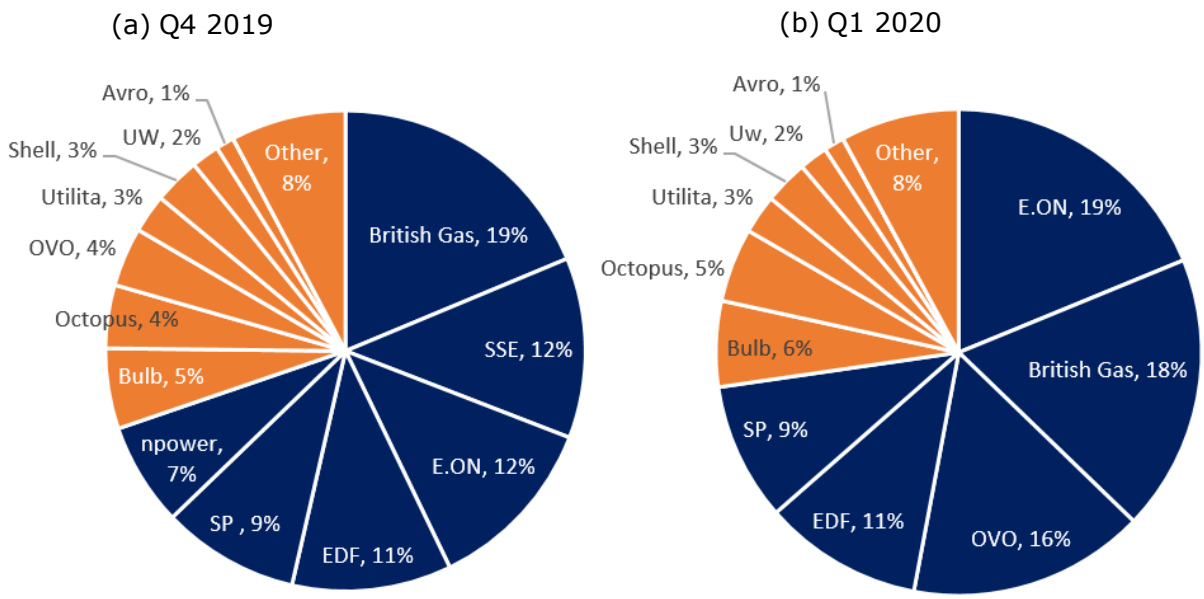
unsustainable pricing practices or business models may harm consumers and distort competition when they fail, for example through leaving significant costs that may need to be recovered from other suppliers and ultimately consumers, as well as by undermining consumer confidence in switching and the market as a whole. Suppliers should therefore be able to demonstrate that they are well prepared to meet their obligations and maintain good quality of service as they grow. This will instil confidence in consumers and incentivise them to engage with the market, further improving the functioning of the competitive process. The changes that we are making through our Supplier Licensing Review help to facilitate this.[55]

Following recent acquisitions, the three largest suppliers share over 50% the market

3.21. The acquisition of SSE by OVO in January 2020 and npower by E.ON in September 2019 has changed the composition and relative market shares of large suppliers, as shown in Figure 15. OVO was previously a medium-sized supplier but now holds 16% of the electricity market. Further, the three largest suppliers (E.ON, British and OVO) collectively share 54% of the domestic electricity market.[56] While these acquisitions raise market concentration to 1,217 HHI, we do not anticipate – in line with the CMAs findings – that there will be a substantial lessening of competition. However, we will monitor closely how competition evolves in the market.[57]

[55] See Ofgem (2020) Statutory Consultation – Supplier Licensing Review: Ongoing requirements and exit arrangements.
[56] Similar commentary holds for the gas market. However, British Gas holds a significantly higher share of the gas retail market (around 27% in Q1 2020).
[57] The CMA approved these acquisitions in 2019 and did not find competition concerns in relation to the supply of domestic consumers. See CMA (2019) "Anticipated acquisition by OVO Group Ltd of SSE Energy Services Group Limited: Decision on relevant merger situation and substantial lessening of competition", and CMA (2019) "Anticipated acquisition by RWE AG of a 16.67% minority stake in E.ON SE: Decision on relevant merger situation and substantial lessening of competition".

Figure 15: Electricity market share after recent acquisitions, 2019 and 2020



Note: Panel (b) shows the market shares of electricity suppliers after the acquisition of SSE by OVO, and Npower by E.ON. Suppliers highlighted in dark blue in panel (a) are the historic large suppliers in December 2019, and in panel (b) the updated configuration after acquisitions.
Source: Ofgem's analysis of Distribution Network Operators data.

Supplier performance and efficiency

3.22. In its Energy Market Investigation, the CMA was concerned that weak consumer engagement gave large suppliers market power to overcharge consumers, through a combination of passing on inefficient costs and/or charging prices that cannot be justified by cost movements (excess profits).[58]

3.23. In a well-functioning competitive retail market, we would expect that over time competitive pressures would promote efficiency and limit the scope for excess profits. The primary aim of the default tariff cap is to protect consumers on default tariffs from being overcharged and ensure they pay prices that more closely reflect the underlying costs of supplying energy.[59] We also believe that the price cap provides an additional incentive for suppliers to improve their efficiency.[60]

[58] CMA (2016), "Energy market investigation: Final report"
[59] Ofgem (2018, p.11) Decision - Default tariff cap - Overview document
[60] Section 1(4) of the Tariff Cap Act states that, in setting the cap, we must have regard for "the need

Suppliers are actively pursuing measures to improve efficiency

3.24. A number of large suppliers are implementing a range of measures to become more efficient and reduce their costs, including:[61]

- Investment in online facilities which enable customers to have more control and self-manage their own energy accounts. [62]
- Securing more competitive terms with third party service providers.
- Internal restructuring to reduce staff headcount and achieve savings on the associated expenditure.

3.25. Medium-sized suppliers are taking measures to improve and maintain efficiency as they grow in size, for example through adopting strategies that focus on core operations and minimize other overheads, or investing in innovations and new technologies to achieve longer-term efficiency gains.

Efficiency improvements may take time to materialise

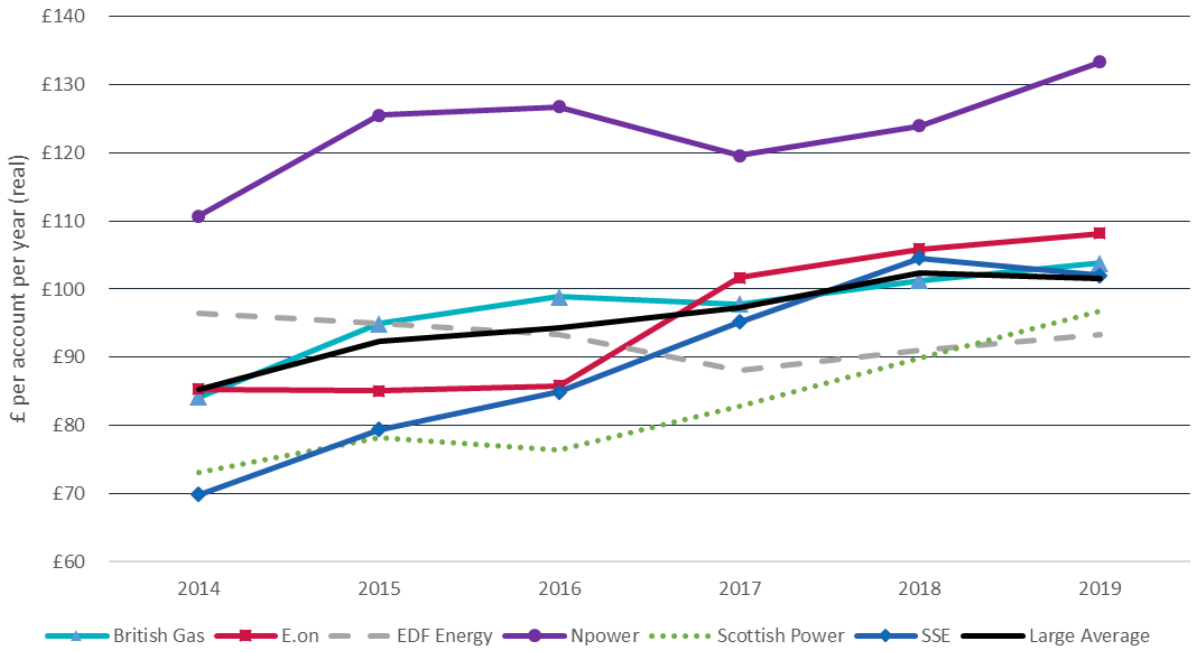
3.26. Figure 16 uses data from the Consolidated Segmental Statements (CSS) to show how indirect operating costs per customer account have evolved for the large suppliers over 2014 to 2019, both on average across the group and for specific suppliers.[63] This metric can be viewed as a proxy for efficiency, because indirect costs capture those costs that suppliers have most control over: they include sales and marketing costs, bad debt costs, costs to serve, IT costs, staffing costs, billing and all meter costs.[64] On average, and across the individual suppliers, indirect operating costs per customer account[65] have risen in real terms between 2014 and

to create incentives for holders of supply licenses to improve their efficiency".
[61] Cornwall Insight – Domestic Supplier Insight Service 2018-2020.
[62] We have also seen some of the large suppliers move their customer service operations overseas to benefit from cost savings. This would only constitute an efficiency gain if customer service levels remain stable or improve as a result of the change.
[63] Data from the consolidated segmental statements of the large suppliers. We divide the indirect cost component of operating costs by customer numbers.
[64] Indirect costs are defined in our existing CSS guidelines: see Ofgem (2015, p.5) CSS Guidelines.
[65] This metric does not control for all factors that may be relevant to efficiency: for example, it does not control for differences in cost-to-serve. All else constant, a supplier with lower cost-to-serve customers (eg, a higher proportion of customers who pay by direct debit or use online services) will appear more efficient by this metric.

2019. This suggests that it may take time for these suppliers to descale their indirect costs as customer numbers fall. The figure also illustrates that there are significant differences across the large suppliers.

3.27. Medium and smaller-sized suppliers do not currently provide comparable information of indirect costs and customer numbers. As a result, we cannot make a like-for-like comparison. However, available information[66] suggests that on average their indirect operating costs per customer may be lower than the average across large suppliers. We expect to be able to analyse this in more detail in any subsequent assessments.

Figure 16: Indirect operating costs per customer account 2014 – 2019



Note: SSE's 2019 CSS runs from 1 Mar 2019 - 15 Jan 2020. To produce an annual estimate of SSE's annual indirect operating cost per customer, we have scaled operating costs to an annual figure.
Source: Ofgem's analysis of data compiled from consolidated segmental statements (CSS).

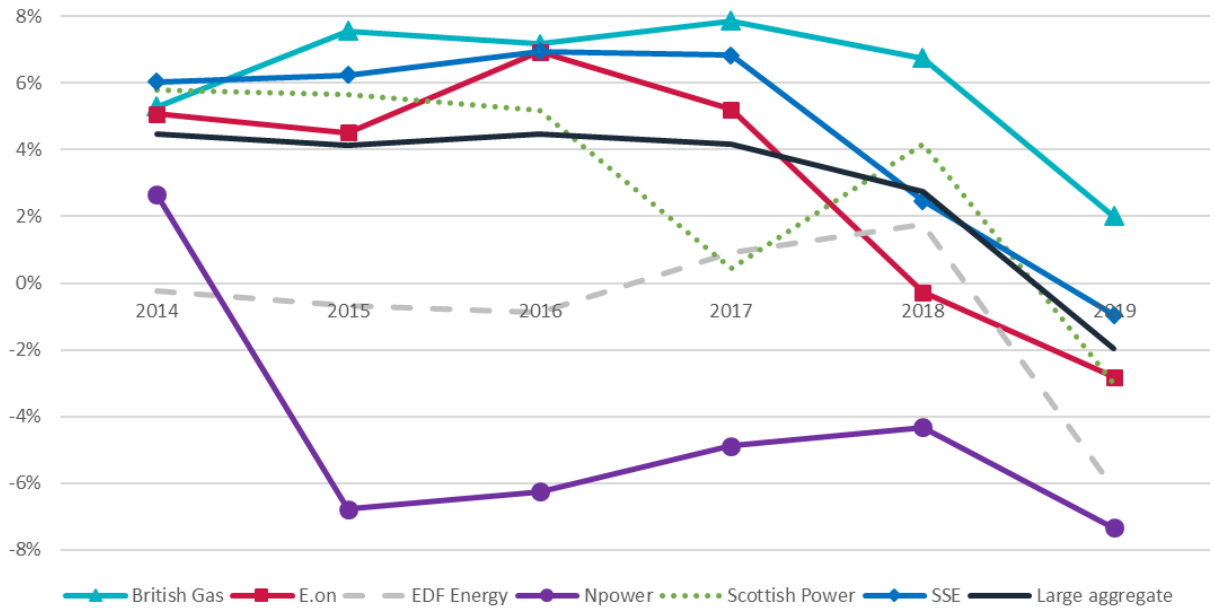
Supplier profitability is falling across the large and medium suppliers

3.28. Our assessment also considers the underlying profitability of suppliers. Figure 17 presents the earnings before interest and tax (EBIT) margins for the large suppliers

[66] We estimate this for select medium suppliers using supply point data from Xoserve and DNOs and administrative expenses listed in each supplier's financial accounts published on Companies House.

in the market between 2014 and 2019, as well as on aggregate across this group. The aggregate EBIT margin has fallen annually since 2016. The falling margins since 2016 may be attributed in part to increased competition, while we have also seen profitability fall since the introduction of the default tariff cap in 2019. Under the default tariff cap suppliers are incentivised to become more efficient and can no longer recover any losses or low margins on fixed tariffs through default tariff customers. However, a supplier's overall profitability is affected by their overall efficiency and pricing decisions across the range of products they offer, including fixed tariffs that are outside the scope of the default tariff cap. As will be discussed in Chapter 4, we have seen that large suppliers have continued to set their fixed tariffs significantly below the price of their default tariffs, in line with pricing behaviour before the cap was introduced. We will continue to monitor how profitability evolves under the default tariff cap.[67]

Figure 17: Aggregate EBIT margins of large suppliers 2014-2019



Note: SSE's 2019 CSS runs from 1 Mar 2019 - 15 Jan 2020.

Source: Ofgem's analysis of data compiled from consolidated segmental statements (CSS).

[67] In the CMA's Energy Market Investigation, they consider an EBIT margin of 2% an appropriate benchmark for retail supply profitability. This figure is for suppliers that carry out their own trading activity. See CMA Energy market investigation 2016 – Appendix 9.13: Retail profit margins

Overall conclusion: Condition 2 is not yet met.

3.29. Consumer engagement with the retail market has increased in recent years (but from a much lower base for those most in need, such as the low income), while switching rates leading up to the Covid-19 pandemic have been high relative to previous years and other markets. This is driving high levels of competition in the domestic supply market, with medium sized suppliers in particular attracting customers away from the large suppliers.

3.30. However, we remain concerned about the size of the disengaged population of consumers and how competition would function for these consumers if the default tariff cap were lifted. Just over half of all consumers[68] do not engage with the market, and this significantly limits their ability to protect their own interests. If the default tariff cap were lifted, it is therefore unclear whether engagement levels across consumers on default tariffs would be at all sufficient to constrain the prices that suppliers set for their default tariffs.

3.31. Finally, the larger suppliers are pursuing efficiency programmes to bring costs closer in line with the efficient benchmark of the default tariff cap. However, these programmes will take time to bear fruit and deliver lasting productivity gains.

[68] From our 2019 Annual Consumer Survey. See Ofgem, Ipsos (2020, p.16) Ofgem Consumer Survey 2019: Tracking data and insights into future energy solutions.

4. Assessing condition 3: fair outcomes for consumers

Chapter summary

In this chapter, **we set out our view that Condition 3 is not yet met.** We have found that:

- Price differentials have not evolved as we expected under the default tariff cap, but may still be lower than if the cap was not in place. There is therefore uncertainty as to how prices would evolve post-cap, with little evidence to suggest that consumers on default tariffs would continue to get fair outcomes in if the default tariff cap were to be lifted.
- There is significant variation in quality of service across suppliers, with customer satisfaction highest among medium sized suppliers, and rising complaints among smaller suppliers. Overall, it is not clear that customer service is improving.

4.1. The competitive process will generate a range of different outcomes for consumers, in terms of the price that they pay for the energy and the quality of service that they receive. Price differentials are a feature of competitive markets and the price that a consumer pays will depend in part on the extent to which they have compared (directly or by proxy) the products or services available on the market. The range of services that a supplier provides to consumers may also vary with price. As we set out in our decision framework, a condition for effective competition is that consumer outcomes are fair, in so far as:[69]

- Consumers should not be overcharged for their energy use, for example through firms making excessive profits or passing on inefficient costs.
- Consumers should receive a good quality of service.
- Consumers should have access to a range of different tariffs to meet their needs.

[69] See Ofgem (2019, p.16) "Decision – Framework for assessing whether conditions are in place for effective competition in domestic supply contracts"

4.2. In this section, we assess how the outcomes that the market is generating in each of these areas has evolved over time, and how they may be expected to evolve going forwards.

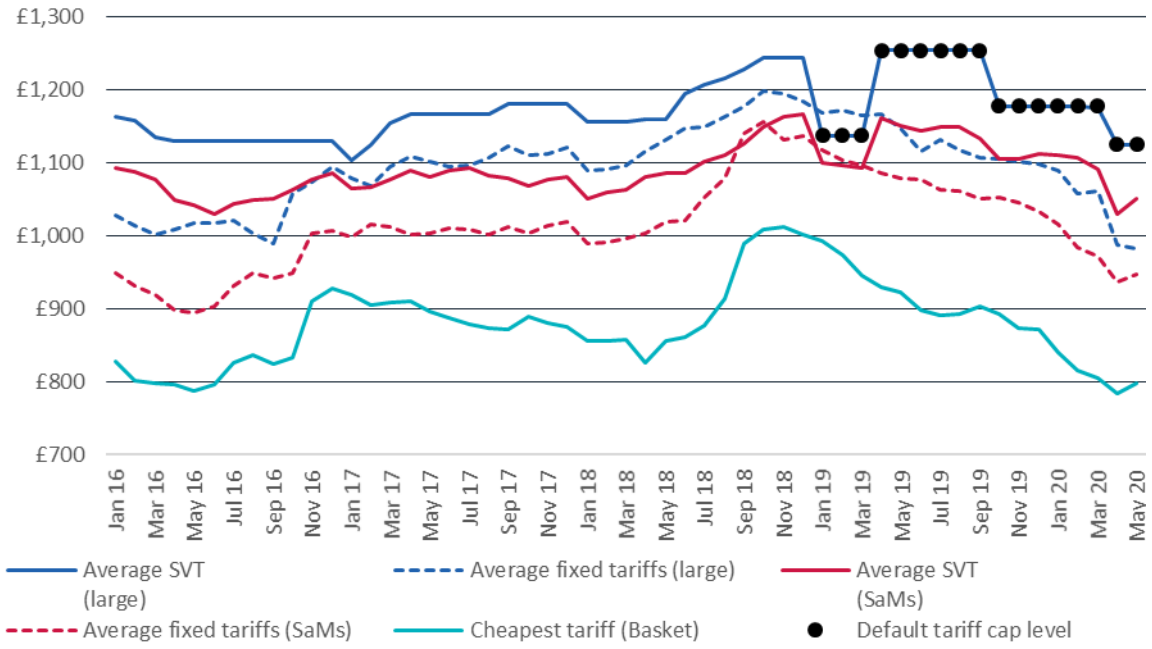
Prices and price differentials

4.3. A market where many consumers are overcharged is not consistent with effective competition. It means that suppliers do not face enough competitive pressure to constrain their price setting, to operate efficiently and to pass-on these more efficient costs to win and retain consumers. While overcharging is a problem in general, it is particularly concerning when low income households are overcharged, because their energy spending is a high proportion of their overall expenditure.[70] The prices that they face can therefore significantly impact their ability to meet their other everyday needs.

4.4. The significant differences in price between default tariffs and fixed tariffs that has arisen over time has disproportionately affected those who are less active in the market, and who are often in vulnerable situations. This is because differences in levels of engagement with the market have led to different pricing strategies and tariff offerings. Less-engaged consumers on default tariffs typically pay more for their energy than engaged consumers on fixed tariffs.

[70] Energy bills account for almost 8% of total household expenditure for households in the bottom income decile, compared to around 4% for the average household. See Ofgem (2019) State of the energy market 2019 report.

Figure 18: Average prices of SVTs and fixed tariffs at typical consumption, 2016-2020 (in 2019 prices)



Note: Small and medium suppliers denoted by SaMs.

Source: Ofgem analysis of Energylinx (Until May 2017) & Energyhelpline (June 2017 onwards). Data correct as of June 2020.

4.5. Figure 18 illustrates how the average prices[71] of standard variable tariffs (SVTs) – predominantly default tariffs – and fixed tariffs have evolved from 2016 to 2020. The market offers a wide variety of different products that fall into these categories, but there are some key observations over time:

- The prices of SVTs and fixed tariffs offered by large suppliers are more expensive than the comparable products of small and medium suppliers. Part of this difference can be explained by the fact larger suppliers face certain

[71] These are average prices at the medium typical domestic consumption value (TDCV), across a range of different tariffs, for dual fuel direct-debit customers. For readability, Figure 18 groups small and medium suppliers together. On average between 2016 and 2020, the average prices of SVTs and fixed tariffs of medium-sized suppliers were more expensive than small suppliers. However, this does not always hold (in particular for the fixed tariffs offered in late 2019 and 2020).

environmental and social obligation costs that smaller suppliers do not.[72] [73] In total, environmental and social obligation costs make-up around 20% of the average electricity bill of a customer with one of the large suppliers.[74] Some smaller suppliers may also be adopting below-cost pricing as part of a strategy to grow, but we would expect this to be supported by responsible risk management measures.[75]

- On average across all types of suppliers, fixed tariffs are typically cheaper than SVTs, though this differential narrowed significantly (and in some cases reversed) around the time of the introduction of the default tariff cap in January 2019. The market also consistently offers to all customers a range of (typically fixed) tariffs that are priced far cheaper than the average SVT or fixed tariff offered by suppliers, and which are highly reflective of wholesale costs.[76]

Price differentials between default (SVT) and fixed tariffs have not significantly narrowed

4.6. We expected that under the default tariff cap[77]:

- The price differential between default tariffs and fixed tariffs would fall, because the cap lowers the price of default tariffs.

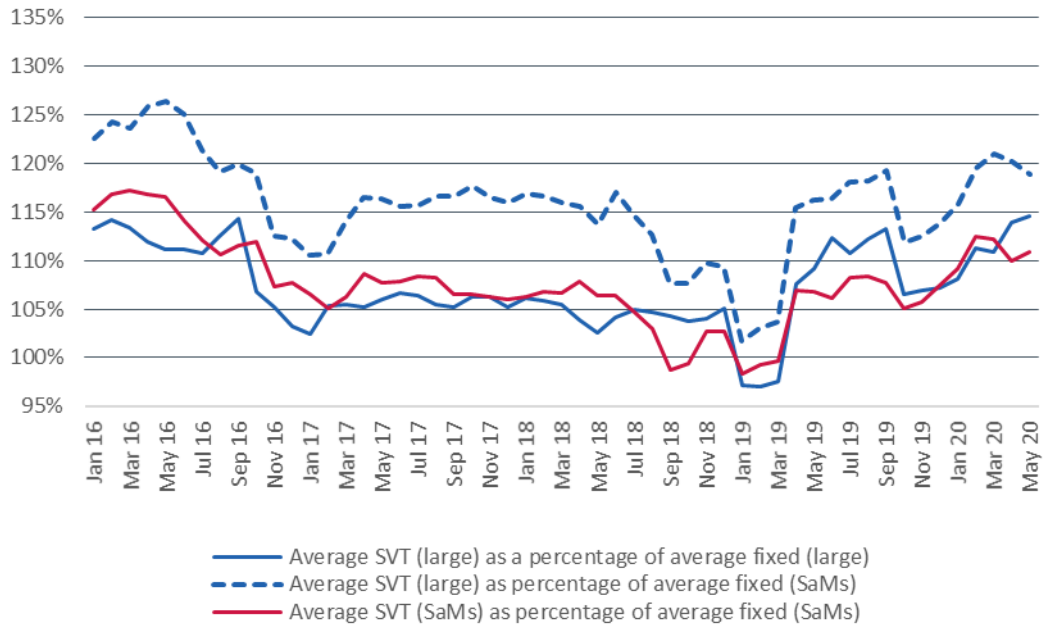
- Price differentials between SVTs and fixed tariffs should become more stable, because suppliers will (on average) purchase their energy closer to the point of

[72] Their customers may also differ in how costly they are to serve, though there is limited evidence in this area.
[73] Some schemes apply to all suppliers, while others only apply to suppliers whose customer numbers and energy outputs pass a given threshold. For example, the Energy Company Obligation (ECO) and Warm Home Discount (WHD) schemes currently apply to suppliers with greater than or equal to 150,000 domestic customers, 300 GWh or electricity supply and 700 GWh of gas supply to domestic customers. The thresholds for these two schemes are falling over time, meaning more suppliers face these costs. For more detail, see Ofgem (2019) Environmental Programmes.
[74] See https://www.ofgem.gov.uk/data-portal/breakdown-electricity-bill.
[75] See Ofgem (2020) Statutory Consultation – Supplier Licensing Review: Ongoing requirements and exit arrangements.
[76] The average price of the basket of cheapest tariffs is calculated to give a representative picture of tariffs generally available to all customers across GB. The cheapest tariffs can include fixed and variable tariffs, may only be available online and may be offered by any suppliers active in the market. We include Tariffs available with *white label* providers are included in the calculation of the market cheapest tariff.
[77] See Ofgem (2018) Decision – Default tariff cap – Overview document.

delivery for SVTs than they did before the cap, to align with the index used in setting the cap.[78]

4.7. While there is only limited time-series data available to consider how the default tariff cap has affected prices, large suppliers have on average set their SVT prices within a few pounds of the cap level, while other suppliers have chosen to charge below the cap level. The fixed tariffs offered by all types of suppliers have been significantly below the default tariff cap level for the majority of the period.[79]

Figure 19: Price differential between SVTs and fixed tariffs, at typical consumption, 2016-2020



Note: Small and medium suppliers denoted by SaMs.

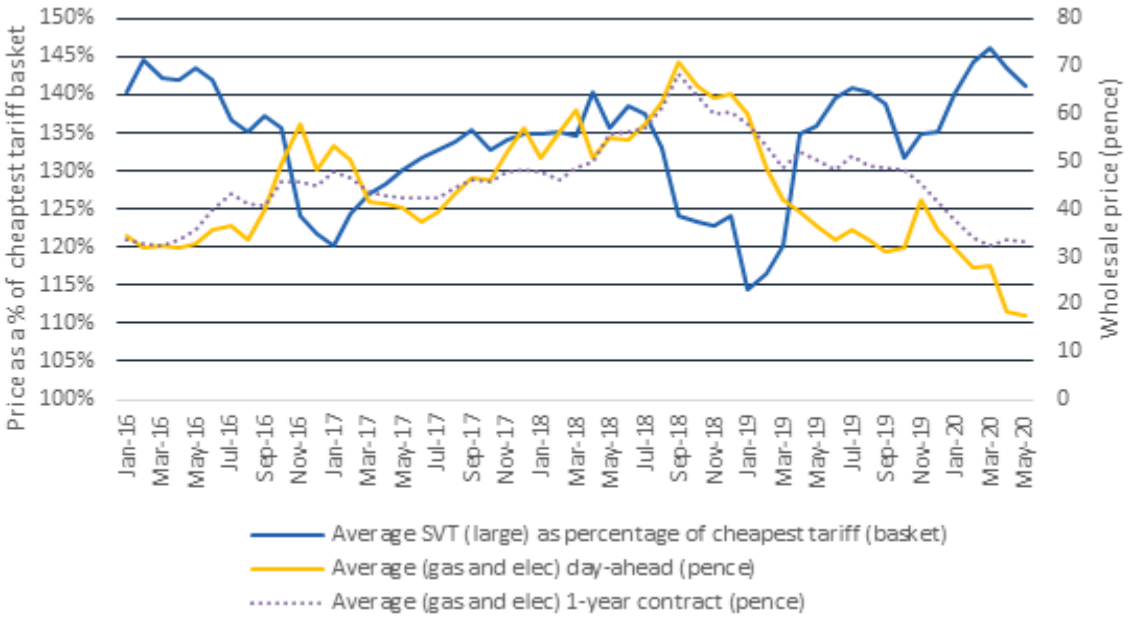
Source: Ofgem analysis of Energylinx (Until May 2017) & Energyhelpline (June 2017 onwards). Data correct as of June 2020.

[78] This 'shorter' approach will reduce the time lag between wholesale price changes passing into fixed tariff prices, and those changes passing into SVT prices, so making the differential between fixed tariffs and SVTs more stable.

[79] Customers on default tariffs therefore still have an incentive to shop around for cheaper deals on the market. However, if they don't, the cap ensures a basic level of protection and ensures they pay a fair price for their energy.

4.8. Figure 19 illustrates how price differentials between SVTs and fixed tariffs – expressed as a percentage – have evolved between 2016 and 2020, both for a certain supplier group (large, small and medium) and between supplier groups. In all cases, the differential fell to its lowest level around January 2019, when the default tariff cap was first introduced. However, since then price differentials have tended to rise and remain at relatively high levels into 2020.[80] A major driver of this has been falling wholesale costs passing through more quickly onto fixed tariffs than standard variable tariffs: Figure 20 illustrates the degree of symmetry between wholesale costs and the price differentials.[81] Pricing may also have become more aggressive in the fixed tariff space. Overall, while price differentials have not narrowed as we expected, it is not clear whether they are lower than if the default tariff cap were not in place. Going forwards, we would expect that the differential will narrow as wholesale prices rise.

Figure 20: Price differentials and wholesale costs



Source: Ofgem analysis of Energylinx (Until May 2017) & Energyhelpline (June 2017 onwards), wholesale prices from Bloomberg ICIS.

[80] The movement of price differentials illustrated in Figure 19 also holds if we alternatively compare the average price of SVTs with the cheapest tariffs available on the market (calculated as an average of the ten cheapest tariffs). These cheapest tariffs tend to be highly reflective of wholesale prices.
[81] Suppliers differ in their purchasing and hedging strategies.

Quality of service

4.9. Just as competitive markets will result in a range of different prices, they will also result in a range of different levels of customer service. As set out in our fairness principles, we expect that where competition is effective customers receive good quality of service, across the range of different degrees of service that they pay for and require.

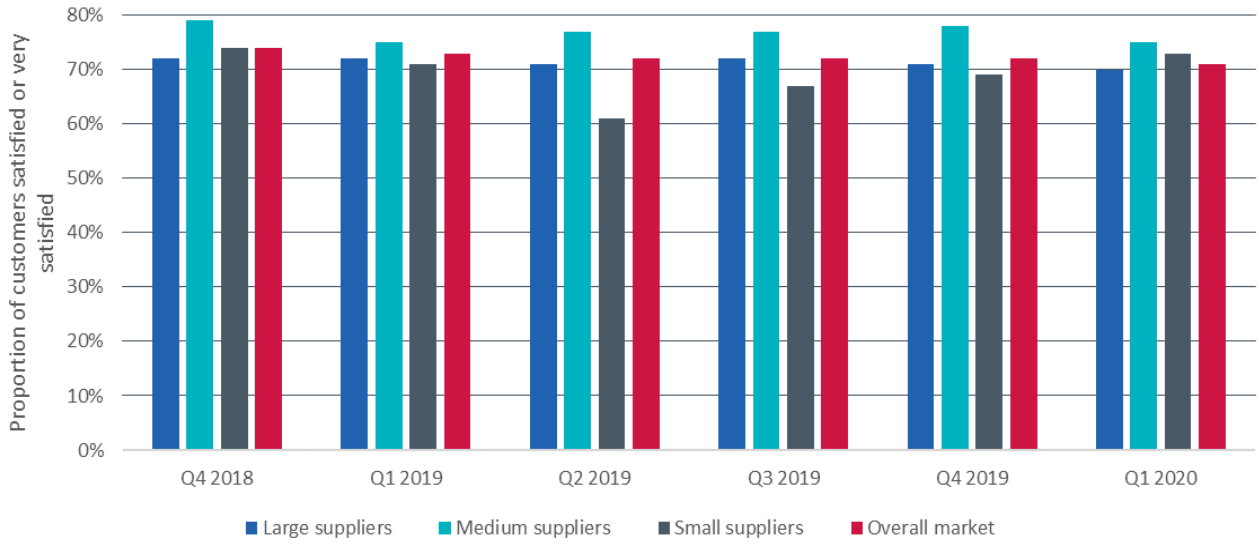
4.10. The expectations that customers have of suppliers are largely transactional; most customers will not think about their supplier or engage with them as part of their daily lives.[82] When they do engage with them, they want to be provided with good customer service and accurate information about 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 fashion.

Consumers are most satisfied with medium suppliers, and least satisfied with the smallest

4.11. Figure 21 illustrates the results from our quarterly energy satisfaction survey on how overall satisfaction with customer service evolved between Q4 2018 and Q1 2020, for the market as a whole and for different groups of suppliers. Overall satisfaction has been relatively stable for large and medium suppliers, with customer satisfaction typically being a few percentage points higher for medium suppliers. For small suppliers, the picture is less clear with satisfaction dipping to 61% in Q2 2019, but rising to 73% in Q1 2020.

[82]See Ofgem (2015) Ofgem Consumer First Panel: Exploring trust and some Retail Market Review remedies.

Figure 21: Overall satisfaction with customer service

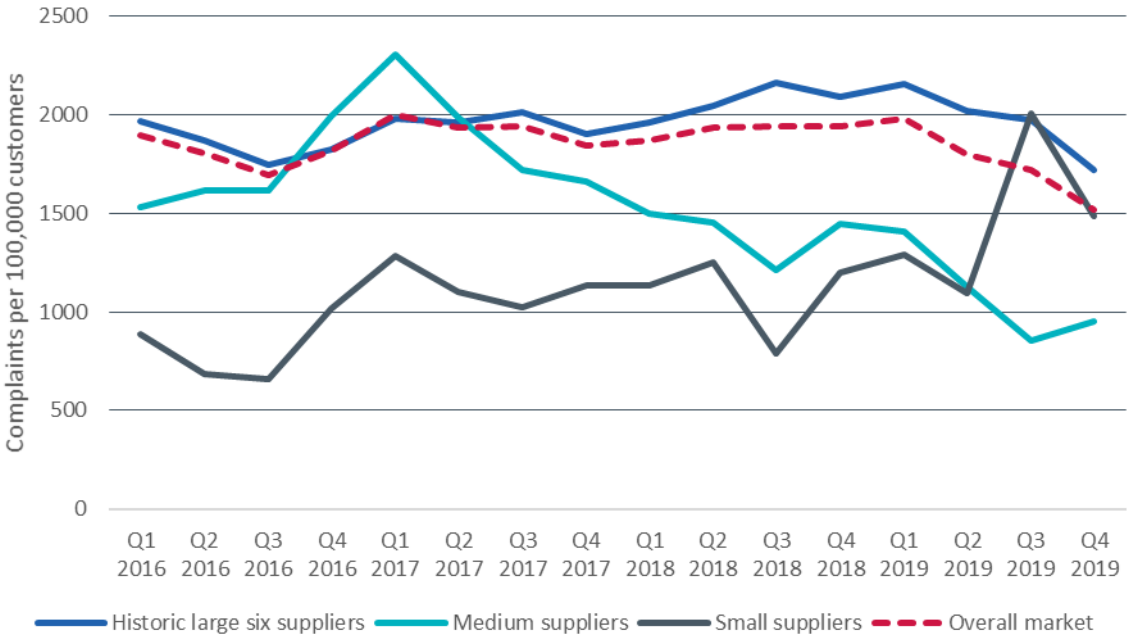


Note: These results are from the survey question "Overall, how dissatisfied or satisfied are you with the customer service you have received from [supplier name]."
Source: Dedicated quarterly energy satisfaction survey commissioned in 2018 by Ofgem in conjunction with Citizens Advice.

4.12. The number of complaints a supplier receives is partly indicative of the quality of its customer service levels. Figure 22 shows the number of complaints that suppliers receive per 100,000 customers. The large suppliers have on average a higher proportion of complaints than other suppliers, averaging just under 2 per 1,000 customers between Q1 2016 and Q4 2019.[83] Across 2016 and early 2017 the level of complaints per 100,000 customers for medium-sized suppliers was high and for a number of months exceeded those received by large suppliers. Since then we have seen a sustained fall in the rate of complaints. Over time, there has been an increase in the rate of complaints for smaller suppliers, in particular in 2019. This suggests that some of the smaller suppliers may be struggling to grow while maintaining high quality service, or are inadequately prepared for growth.

[83] This is a reduction compared to the levels see across 2014 and 2015, when complaints for large suppliers averaged just over 3 per 1,000 customers. This suggests that competitive pressure has resulted in an improvement in the quality of service offered by the large incumbents.

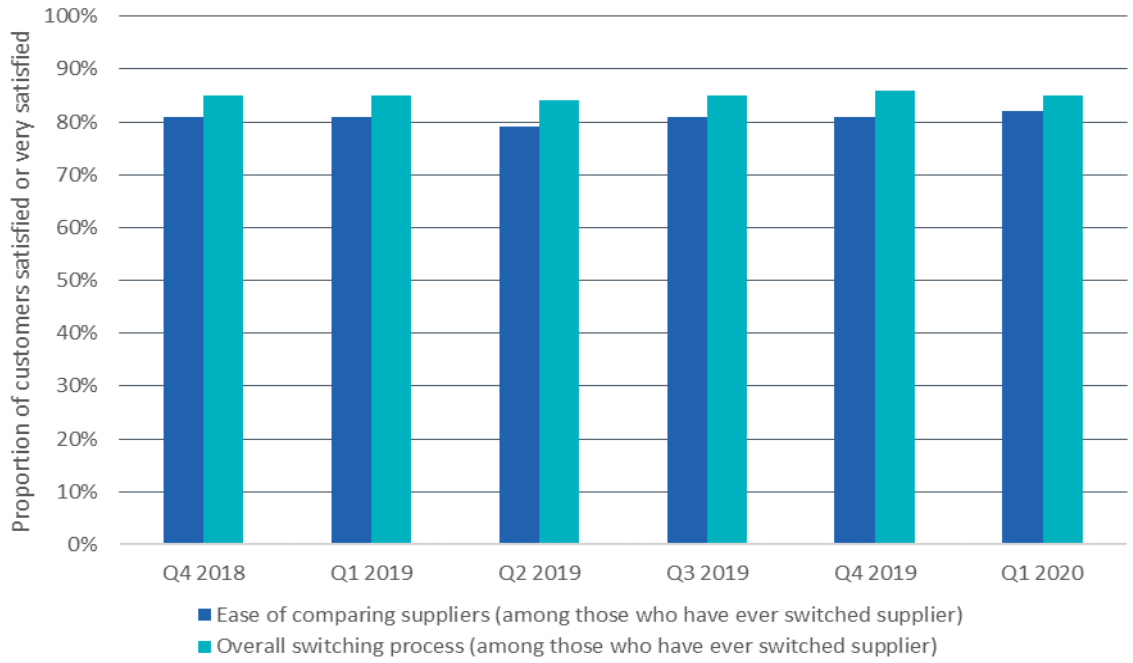
Figure 22: Complaints per 100,000 customers



Note: Due to Covid-19, we gave suppliers an extension on the deadline to submit Q1 2020 complaints data up to July 2020.
Source: Ofgem analysis of supplier data. Data correct as of February 2020.

4.13. If consumers choose to switch suppliers, an important outcome for them will be their experience of the switching process. Figure 23 illustrates how satisfied consumers who switched suppliers were, both with the ability to compare the different offerings of suppliers and with the switching process. These proportions have not changed or improved significantly over the past year, with the proportion of consumers not reporting being satisfied or very satisfied averaging around 20% for the ease of comparing products, and 15% for the switching process. Overall, consumers are marginally more satisfied with the switching process than with the ease with which they are able to compare products and prices across suppliers. This suggests that some barriers remain to consumers being able to compare and understand the different offerings on the market.

Figure 23: Customer satisfaction with the switching process and comparing suppliers

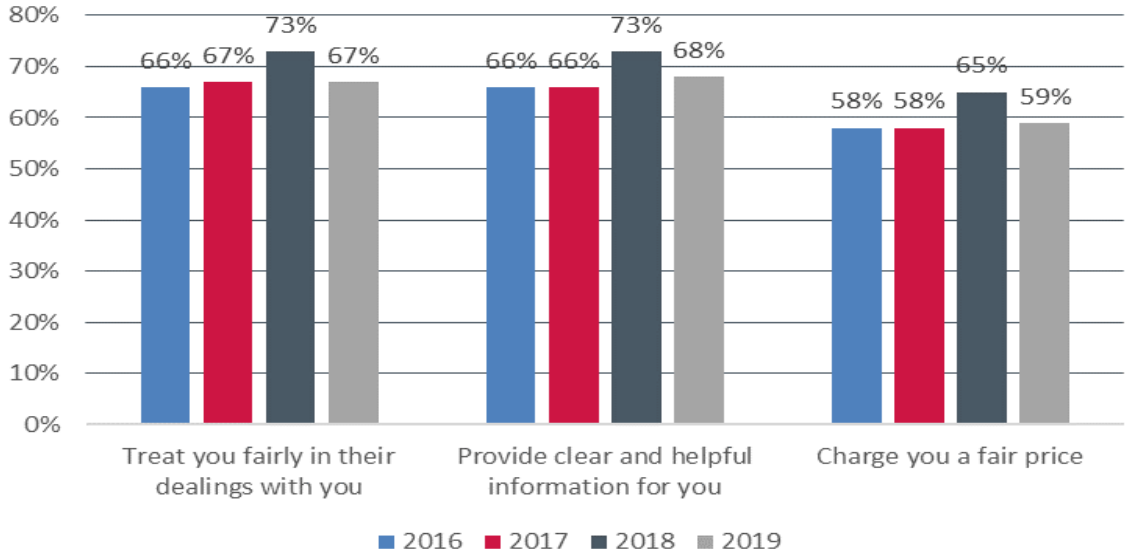


Note: These results are from the survey question "Please can you tell me how dissatisfied or satisfied you were with the following aspects of your switch to another supplier: ease of comparing suppliers and prices; the switching process overall.
Source: Dedicated quarterly energy satisfaction survey commissioned in 2018 by Ofgem in conjunction with Citizens Advice.

Consumers trust suppliers to treat them fairly, but less so when it comes to prices

4.14. In our annual Consumer Survey, we ask consumers about their overall trust and confidence in the market, in terms of whether they think that suppliers treat them fairly, provide clear and helpful information and charge a fair price. On average, around 70% of consumers trust suppliers on the first two issues, while just over 60% of consumers think that suppliers will charge them a fair price (see Figure 24). Confidence and trust across each of these three dimensions fell in 2019 relative to 2018, but remains significantly higher than levels dating back to 2014.

Figure 24: Consumer trust and confidence



Note: These results are from the survey question "To what extent do you trust or distrust your energy supplier to: Treat you fairly in their dealings with you; Provide clear and helpful information for you, Charge you a fair price for your gas and electricity."
Source: Ofgem Consumer Surveys 2016, 2017, 2018 and 2019.

4.15. Our annual consumer survey data[84] suggests that overall levels of trust in energy suppliers are comparable to those for internet providers and insurance companies, but far lower than the levels of trust that consumers have for banks and building societies.

Range of tariffs to meet needs

4.16. Consumers differ in their preferences and energy needs: an energy market that is working well for consumers will provide a range of different products to reflect these differences. For example, an increasing number of consumers may prefer green energy tariffs or want to switch to smart tariffs.[85]

[84] For example, see Ofgem (2020) Consumer Engagement Survey 2019 Data Tables.
[85] The total number of tariffs available to customers averaged 231 between July 2019 and June 2020. We have seen a reduction in the number of new tariffs launched between March and May 2020.

4.17. The number of tariffs offered by suppliers as "green" or "100% renewable" has accounted, on average, for 50% of the total number of tariffs launched in the market between June 2019 and May 2020. From January to October 2019, the number of domestic customer accounts on electric tariffs having 100% renewable sources increased by 18%.[86] As set out in our decarbonisation programme action plan, it is important that consumers can trust that tariffs marketed as "green" will make positive environmental impacts on the planet, and that the environmental benefits of a particular tariff or supplier are not overstated (called "greenwashing"). We would expect suppliers to be transparent about what constitutes a green tariff.[87]

4.18. We would expect that the range of smart tariffs on offer to consumers will increase as the smart meter rollout progresses further. 13% of customers were on smart tariffs in 2019.

Overall conclusion: Condition 3 is not yet met.

4.19. Overall, price differentials between default and fixed tariffs have not evolved as we expected under the default tariff cap, but may still be lower than if the cap were not in place. There is therefore uncertainty as to how prices and price differentials would evolve post-cap, with little evidence to suggest that consumers on default tariffs would continue to get fair outcomes in terms of price if the default tariff cap were to be lifted. This, in combination with the increased pressure on household budgets due to Covid-19, substantially increases the risk of lifting the default tariff cap.

4.20. For competition to be effective, we would expect that consumers have the confidence that switching to potentially cheaper deals will not result in a reduction in the quality of service they receive. Overall, it is not clear that quality of service is improving.

[86] Ofgem analysis of EnergyHelpline data.
[87] See Ofgem (2020) Ofgem decarbonisation programme action plan.

Appendices

Index

Appendix 1: Section 7 of the Tariff Cap Act

Section 7 of the Domestic Gas and Electricity (Tariff Cap) Act 2018 sets out the key requirements and timelines for producing this review:[88]

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

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