



# Competition in the energy retail market

A report commissioned by Northumbrian Water

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# 1. Executive summary

This report, prepared for Northumbrian Water, summarises our study of four major competition investigations into the energy retail market over the last decade. It sets out the possible implications of the investigations for Ofwat when considering the costs and benefits of extending retail competition to household water customers in England.

This section sets out:

- (i) the context for our review;
- (ii) our main findings;
- (iii) the possible implications of our findings for Ofwat's review; and
- (iv) the structure of this report.

### 1.1. Introduction and context

Last year, the UK government asked Ofwat to provide an assessment of the costs and benefits of extending retail competition to household water customers. In January this year, Ofwat issued a call for evidence, seeking early contributions to feed into its assessment.

To help respond to Ofwat's call for evidence, Northumbrian Water has commissioned Economic Insight to study the major competition investigations in the energy retail market and consider the implications of these investigations for Ofwat's review.

This report summarises our study of the four major competition investigations in the last decade, namely:

- the *Energy Supply Probe* conducted by Ofgem in 2008;
- the *Retail Market Review* conducted by Ofgem in 2010;
- the *State of Competition in the Energy Market Assessment* conducted by Ofgem, the Office of Fair Trading (OFT) and the Competition and Markets Authority (CMA) in 2014; and
- the *energy market investigation* conducted by the CMA, which is on-going and due to finish in June this year.<sup>1</sup>

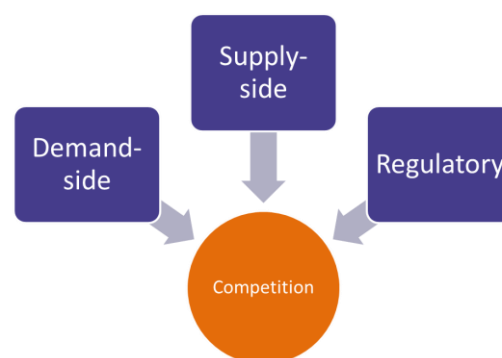
### 1.2. Our main findings

We examined the features and characteristics of the energy retail market, which Ofgem and the CMA considered when assessing the effectiveness of competition in the energy retail market.

We found that they have considered, to varying degrees, the full range of possible *supply-side* (e.g. barriers to entry), *demand-side* (e.g. customer inertia) and *regulatory* impediments to competition.

But perhaps the most constant and salient feature of the reviews is the focus on the *demand-side* impediments. In particular, all of the reviews have identified *weak customer engagement and response* as a problem in the energy retail market. Both Ofgem and the CMA have expressed concern that the lack of customer engagement may have given rise to market power, which retailers have been able to exploit through their pricing practices.

Figure 1. Drivers of competitiveness



The reasons given for the lack of customer engagement have included:

- the *inherent characteristics* of electricity and gas, such as their actual or perceived “homogenous” nature; and
- the *behaviour of suppliers* including the number and complexity of the tariffs they offer.

Arguably, the latter explanation featured more prominently in the earlier investigations conducted by Ofgem, and the former explanation has featured more prominently in the on-going investigation by the CMA.

### 1.3. Possible implications of our main findings for Ofwat's review

While it will be important for Ofwat to consider the extent of “read across” from the energy retail market to a water retail market, the four major investigations point to the following implications for Ofwat's review.

- » First, in determining how competitive a household water retail market is likely to be (and hence the benefits of introducing competition), **Ofwat should place significant emphasis on understanding the likely level of customer engagement in the market.** How many customers might switch? What type of customers might switch? Will the behaviour of “switchers” protect “non-switchers”?
- » Second, in doing so, Ofwat should seek to establish **whether the inherent characteristics of water retail mean that the ability and/or incentive of customers to search and switch deals is likely to be low,** irrespective of the behaviour of suppliers. To what extent are customers interested

<sup>1</sup> It is important to note here that our study captures the views of Ofgem and the CMA – not all stakeholders have agreed with their findings and remedies.

in the possibility of switching water retailer? What scale of price saving / service improvement would be needed to encourage switching?

- » Third, to the extent that the inherent characteristics of water retail would not be expected to stand in the way of customer engagement, Ofwat will need to consider what, if any, safeguards it should put in place to prevent or deter suppliers from engaging in practices that could reduce search and switching behaviour. **A key challenge to consider will be whether any such safeguards could be designed in a manner that do not reduce the ability and incentive for suppliers to compete.** What should be the balance between ex-ante and ex-post regulation? What role, if any, should Ofwat have in facilitating search and switching behaviour e.g. developing its own price comparison service? Should Ofwat limit the number or type of tariffs available? To what extent will price discrimination (between regions and/or customers) be viewed as “ok”?
- » Finally, to help develop evidence in this area, Ofwat could consider using a range of **comparator retail markets**, such as the (non-household) water retail market in Scotland. Ofwat could also consider developing primary evidence using **survey and experimental techniques** (such as those used by the Financial Conduct Authority and the CMA’s predecessor, the OFT).

#### 1.4. Structure of this report

The next section of this report sets out our review of the four major investigations listed above in chronological order. The last of section of this report identifies the key themes and implications emerging from our review.





## 2. Review of the four major energy retail market investigations

This section of our report sets out our review of the four major competition investigations into the energy retail market over the last decade.

For each investigation, we summarise: the motivation for the investigation; the issues considered; the findings; and, where relevant, the remedies pursued.

This section considers each investigation in chronological order:

- (i) the Energy Supply Probe in 2008;
- (ii) the Retail Market Review in 2010;
- (iii) the State of Competition in the Energy Market Assessment in 2014; and
- (iv) the on-going CMA market investigation.

## 2.1. The Energy Supply Probe (2008)

The Energy Supply Probe (The Probe) was launched in 2008 by Ofgem to investigate the functioning of competition in the Great Britain (GB) gas and electricity retail supply for markets serving domestic customers (households) and small businesses (SMEs).

Figure 2. The Probe Key Milestones



The Terms of Reference set out by Ofgem in February 2008, stated the investigation would cover:<sup>2</sup>

- the customer's perspective and experience of the market including access to information and barriers to switching supplier;
- suppliers' market shares, switching rates for different groups of customers (online, dual fuel, single fuel and pre-payment).
- the competitiveness of suppliers' pricing in the different market segments and customer movement between payment types as well as suppliers;
- the relationship between retail and wholesale energy prices; and
- the economics of new entry and the experience of companies trying to enter the energy market.

While the focus of The Probe was on the retail market for households and SMEs, the investigation also took into consideration the wholesale market, but only to the extent it was necessary to assess whether the retail markets are working effectively.

### 2.1.1. Motivation

Prior to the launch of The Probe, Ofgem responded to concerns surrounding the increase of household bills; and also allegations in the press of collusion between energy suppliers, by issuing a press release in January 2008 assuring the Chancellor "it has no evidence that the recent energy price rises are a result of industry collusion" and requested sight of evidence of any anti-competitive activity.

Notwithstanding the above, public concerns surrounding the rise of consumers' bills, in particular for households and SME's, remained. A typical household's energy bill more than doubled since early 2004 and many customers were struggling to pay their bills. This led The Probe to focus on three main areas of concern:

- increasing wholesale and retail prices;
- synchronisation of prices

i.e. cartels; and

- vulnerable customers.

In addition to the above, concerns were heightened by the global financial crisis, putting pressure on household budgets and also the effects of rising global energy costs (oil, coal and gas). As a result, vulnerable customers were particularly affected.

### 2.1.2. Issues

With the above three areas in mind, The Probe considered the areas set out below.<sup>3</sup>

- » **The GB energy supply markets.** This assessed: (i) the market position of the Big 6 suppliers; (ii) their market share and extent of vertical integration; and (iii) concentration in the market.
- » **Switching and its drivers.** This reviewed the evidence on: (i) switching; (ii) factors driving customer switching decisions; and (iii) how effective it has been in exerting price discipline on the market.
- » **Consumer characteristics and behaviour.** This looked at: (i) the levels of customer awareness; (ii) factors that influence consumer decisions to engage in the market; and (iii) the issues and barriers they face in doing so.

<sup>2</sup> Ofgem launches Probe into Energy Supply Markets, Ofgem press release, February 2008.

<sup>3</sup> The Energy Supply Probe – Initial Findings and Remedies, Ofgem, 2008.

- » **Barriers to entry and expansion.** This examined: (i) the history of entry and expansion; and (ii) a number of issues raised by new entrants and small suppliers.
- » **Supplier behaviour.** This focused on the Big 6 and considered: (i) their pricing strategies for both retail and with respect to particular consumer segments; and (ii) their record of product innovation and cost reduction.
- » **Impact on consumers both as a whole and different groups, such as: electricity only; Pre-Payment Meter (PPM); standard credit; and Scottish and Welsh consumers.** This was conducted by assessing: (i) the scale of the impact of suppliers pricing policies; and (ii) the number of consumers affected (looked at profitability from each customer base).
- » **Vulnerable customers.** This looked at the extent vulnerable customers were affected by the issues recognised above, by identifying the range and number of customers that are of concern.

Key evidence used to assess the above characteristics included: (i) commissioning Ipsos MORI to look at factors which influence customers; and (ii) company information through the use of their powers under the formal information gathering requests.

### 2.1.3. Findings

While there were concerns in the market, The Probe found the following to be working well:

- the fundamental structures of a competitive market to be in place, and the transition to effective competitive markets was advanced and continuing; and importantly,
- while the Big 6 matched each other's retail pricing structure closely, it found there to be no evidence of a cartel and that prices were, in fact, the result of changing wholesale costs. Related to this, changes in wholesale costs tended to be passed through to retail prices with a lag, but the evidence as to whether this lag was longer when prices were falling or rising was inconclusive.

However, they also found a number of areas where this was not the case and the transition to an effective competitive market should be accelerated.<sup>4</sup> Of particular concern was: (i) structural features and supplier behaviour; (ii) inadequate customer

engagement in the market; and (iii) poor decision making by customers, both household and SME's.

- » Firstly, structural features and supplier behaviours were found to be partly due to the legacy of the industry at time of privatisation. The number of new entrants had decreased significantly, and of those who have remained in the market, The Probe found there to be no sizable 'competitive fringe', as the Big 6 retained 99% of the market (market share based on number of customers). As a result, The Probe found the biggest barriers to entry were caused by the effect of pricing policies of the Big 6 and low levels of electricity liquidity.

In relation to the above, it also found issues around **differential pricing**, in the areas of: (a) in and out of area (ex-incumbent areas); (b) electricity versus gas; and (c) payment methods.

In particular, **prices were consistently higher for in-area customers**; margins on electricity were consistently higher than gas; and the price differential charged to standard credit and some PPM customers appears to be higher, where there was no cost justification for these differences.

- » Secondly, while evidence revealed favourable switching rates when compared to other GB service industries, this was only amongst a small group of active customers. Coupled with this, **aggressive selling tactics** by suppliers meant that some customers were switching as the result of poor or inadequate information, with around a **third of switches not receiving a price reduction**.<sup>5</sup> Overall, engagement in the market was relatively small and of a big concern, particular where vulnerable customers were concerned.
- » Lastly, The Probe also had concerns for SME customers, who in general, have access to a wider range of contracts than domestic customers. Albeit, evidence found switching to be lower than in the household sector, and largely due to customers' difficulties in assessing competing offers; and the **transparency of contract terms and conditions, namely the use of contract roll-overs** by suppliers.

<sup>4</sup> *The Energy Supply Probe – Initial Findings and Remedies, Ofgem, 2008.*

<sup>5</sup> *Energy Supply Probe – proposed retail market remedies, Ofgem, 2009*



#### 2.1.4. Remedies pursued

Following consultation and refinement of initial proposals, Ofgem developed a package of remedies to address the above issues.

- » In the first instance, Ofgem addressed **undue / unfair price differentials surrounding unjustifiable tariff differentials** between payment types, regions and customers on and off the gas grid, by modifying the standard conditions of the Electricity and Gas Supply Licences (SLCs), which saw the introduction of conditions: (a) requiring that any differences in terms and conditions for payment methods is *cost reflective*; and (b) prohibiting *undue discrimination* in terms and conditions offered to different groups of customers.<sup>6</sup>
- » The second part of the package centred on **promoting effective customer engagement**. This included conditions on the provision of information provided to customers on **their bills and annual statements**, in order to encourage customer participation in the market.
- » In addition to the above, Ofgem also introduced in to the licence a standard to **help vulnerable customers and indebted households** who are blocked from switching.
- » Relatedly, yet specific to SME's, Ofgem remedied information barriers to improve SME's ability to engage in the market, **by restricting (not eliminating?) the ability of suppliers to automatically roll-over SME's on fixed term contact** when their existing contract expires.

During The Probe consultation process, Ofgem considered options to simplify the array of tariffs that suppliers have to choose from, this included:<sup>8</sup>

- preventing firms offering tariffs with certain, more complex structures;
- restricting the number of tariffs suppliers can offer; and
- having core benchmark tariffs upon which comparisons could be focused.



*Ofgem prohibited undue discrimination surrounding unjustifiable tariff differentials between payment types, regions and customers on / off the gas grid.*

Following **concerns around limiting the flexibility and innovation within tariff structures**, and issues associated with the installation of smart meters, this option was not pursued at this time.

In relation to both improving customer engagement in the market and addressing the poor conduct of suppliers, Ofgem set out an overarching **voluntary Standards of Conduct** stating the expectations of suppliers' behaviour, and information they should provide, when dealing with domestic and small business customers.

Ofgem also considered various other remedies including industry self-regulation; and consumer protection legislation, however, there were concerns around their appropriateness and as such, ruled out these options.

Finally, in order to address concerns surrounding the wholesale market **Ofgem mandated the publishing of detailed annual financial information for the Big 6 vertically integrated companies** which includes: profits, underlying cost and revenue information.

<sup>6</sup> This was seen as an interim measure until competition became effective. It expired on 31 July 2012. (Ofgem, 2013).

<sup>7</sup> Ofgem's earlier preferred option.

<sup>8</sup> Energy Supply Probe – proposed retail market remedies, Ofgem, 2009.

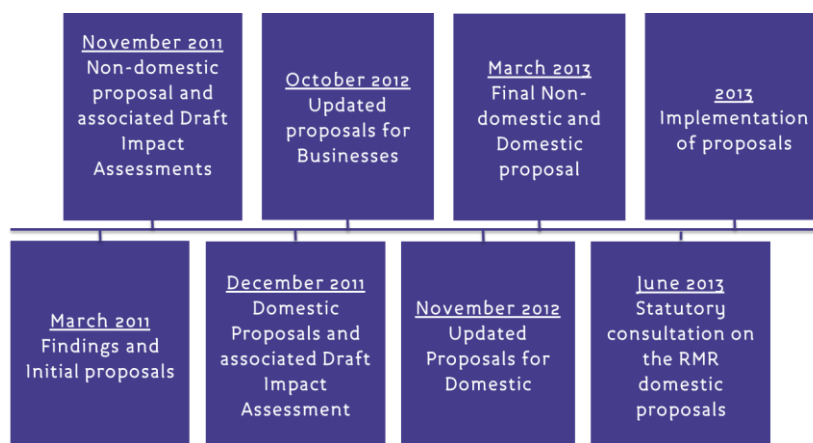
## 2.2. The Retail Market Review (2010)

Ofgem conducts regular monitoring of the retail market, and following concerns raised in the 2010 market update,<sup>9</sup> the Retail Market Review (RMR) builds on the findings from Ofgem's 2008 Energy Supply Probe, adding to the analysis and evidence, along with conducting further work in order to determine the effectiveness of the energy retail market.

Beginning with the publication of the Findings and Initial Proposals report, published in March 2011, the RMR saw the implementation of two proposals specific to domestic and non-domestic customers:

- June 2013: Implementation of New Standards of Conduct for suppliers – business customers; and
- August 2013: Implementation of Simpler Tariff Choices and Clearer Information.

Figure 3. RMR Key Milestones



### 2.2.1. Motivation

Consumer engagement and enhancing competition was at the centre of the remedies following the 2008 Probe. However, concerns remained in some areas. Of particular concern was that companies were not complying with the standards, namely the “expectation that suppliers take all reasonable steps to not offer products that are unnecessarily complex and confusing”<sup>10</sup>.

### 2.2.2. Issues

These concerns resulted in the launch of the RMR to determine how the remedies implemented during The

Probe reforms had progressed, and to establish whether further policies were required.

### 2.2.3. Findings

The review found that there had been improvements in some areas since The Probe, which consisted of:

- » **Reductions in unjustifiable price differentials.** In particular, PPM customers now paid, on average, less than those on standard credit; the cross-subsidisation between electricity and gas no longer existed; and the differential between in vs out of area, had almost halved. Additionally, any remaining differentials were consistent with Ofgem's understanding of differences in costs.
- » **Introduction of new licence conditions.** Saw increases in the use of introductory offers, especially for customers signing up online.

Despite the above improvements, the issues regarding customer engagement and supplier behaviour still

existed especially with regards to the growing complexity of pricing information; and the high number of sticky consumers. More specifically, the three key areas of concern included the following.

- » **Tariff structures**, which included: (i) the large number; and (ii) the complexity, of tariffs.

- » **Insufficient information**, in particular the gaps and lack of clarity in the information given to consumers by

suppliers.

- » **Lack of trust in suppliers** and heightened by poor supplier conduct.

In addition to the above areas of concern, the review also confirmed the evidence found in The Probe, that there are **structural features** in the industry that are likely to have an effect on **weakening competition**, such as:

- highly concentrated regional markets;
- customer segmentation possibly permitting suppliers to make higher margins from sticky customers;

<sup>9</sup> Update on Probe Monitoring: tariff differentials and customer switching, Ofgem, 2010.

<sup>10</sup> The Retail Market Review – Final domestic Proposals, Ofgem, March 2013.



- lack of wholesale products and transparency; and
- further evidence of companies pursuing similar pricing strategies.

**The level of customer engagement was a particular concern for ‘sticky’ customers** – i.e. those who remain with their incumbent electricity supplier – are involved. Not only do incumbents retain a high proportion of customers which they inherited at privatisation, they also have the ability to segment their customer base and respond to competition by recovering costs and margins from these ‘sticky’ customers.

The review separated out domestic and non-domestic engagement issues and was satisfied with non-domestic charges, as the sector was in general:

- more competitive;
- customers were more engaged; and
- customers didn’t report as high levels of mistrust in their suppliers.

This is because, compared to the domestic market, there are more suppliers, a lower incumbent market share, higher switching rates and more responsive prices.<sup>11</sup> However, **concerns existed with regards to smaller businesses** in the market, and as such the review focused on addressing these concerns, which included **transparency** and **inadequate information**.<sup>12</sup> Put differently, three areas were identified as not working well.

- » **Unclear contact information**, namely with regards to contract end dates and rolling over customers onto more expensive deals / contracts.
- » **Billing**, which included a lack of clarity and accuracy of bills.
- » **Transfer problems**, in particular the behaviour of suppliers and third party intermediaries (TPIs) during switching processes.

Ofgem concluded that more action was needed to make the energy retail markets work more effectively in the interests of consumers. Following further research and analysis, Ofgem proposed several remedies in order to address the above, the following section sets out the remedies pursued by Ofgem.

#### 2.2.4. Remedies pursued

To combat issues with **supplier behaviour** and **overcoming domestic customers’ lack of understanding and trust in the market**, Ofgem moved from voluntary high level standards, to more prescriptive remedies which focused around three key themes with the aim of improving:

- simplicity;
- clarity; and
- fairness.

Remedies pursued were centred on **changing the tariff structures** provided by energy suppliers and were designed to make the retail market simpler, clearer and fairer for domestic customers.

These remedies required modification of the domestic supply licence conditions and included:<sup>13</sup>

- limiting the number of tariff choices a consumer would face and standardising tariff structures;
- creating rules designed to simplify bundles, discounts and reward points;
- proposals to facilitate collective switching; and
- providing consumers with transparency on white label suppliers.

Other options such as: (i) simplifying tariffs without a cap; (ii) one tariff per payment method in the standard market; and (iii) principles-based approaches, were rejected because they weren’t doing enough to convince customers there has been a change (such as option i) or the potential to be anti-competitive (such as option ii).

In addition to the above remedies, Ofgem also proposed to introduce communication tools to help consumers to navigate the market, for example, a Tariff Comparison Rate; personalised projections; tariff information label and regular prompts as to what the cheapest tariff is with your supplier; and new rules to oblige all energy suppliers to treat customers fairly through binding Standards of Conduct.

Remedies for SMEs on the other hand, were motivated **to improving the behaviours of the suppliers** and ensuring businesses, **particularly smaller**

<sup>11</sup> *The Retail Market Review – Updated proposals for businesses, October 2012.*

<sup>12</sup> *The Retail Market Review – Final non-domestic proposals, Ofgem, March 2013.*

<sup>13</sup> *The Retail Market Review – Draft impact Assessment for the updated Proposals for domestic proposals, Ofgem.*

**businesses**, can get **best deal** from the market with ease. Remedies pursued includes:<sup>14</sup>

- amending existing rules to bring more businesses under Ofgem’s micro-business projections;
- new rules to make processes clearer and simpler for smaller businesses; and
- new sanctions on energy suppliers who do not deal with smaller business customers, when they have a deemed contract, or when billing.

Ofgem also considered alternative options, such as expanding the existing rules based on: meter type, number of employees and turnover; including the EU small business definition; and including non-household (NHH) metered customers, however due to difficulties in verifying information; the appropriateness of the metrics as indicators of the relative importance of energy to the business; and uncertainty,<sup>15</sup> Ofgem did not pursue these.



*Remedies were centred on the simplification of tariff structures, limiting the number of tariff choices and standardising their format.*

In summary, Ofgem’s objective of the above remedies was to make it easier for consumers, both domestic and SME’s, to engage in the market more effectively so that they can get better deals from their suppliers, which will in turn, put competitive pressure on suppliers pricing and services.

<sup>14</sup> *The Retail Market Review – Final non-domestic proposals, Ofgem, March 2013.*

<sup>15</sup> *The Retail Market Review – Draft impact Assessment for the updated Proposals for businesses, Ofgem.*



### 2.3. State of Competition in the Energy Market Assessment (2014)

As part of Ofgem's RMR proposals, and in response to the Energy and Climate Change Committee, Ofgem committed to monitor the impact of its retail reforms and report annually on its assessment of the market. The Secretary of State asked Ofgem to work with the OFT and CMA to deliver the first assessment by the end of March 2014.<sup>16</sup>

#### 2.3.1. Motivation

The purpose of this assessment was to report on how effective competition in the energy market is serving the interest of households and small businesses.

At the time of the assessment, RMR reforms were still being implemented and the liquidity reforms had not yet begun, therefore, the assessment examined both features of the market as it stands, and the extent to which Ofgem's reforms were expected to address any competition issues identified.

Figure 4. State of the Market Key Milestones



#### 2.3.2. Issues

In order to assess how well the market was progressing towards an effective competitive market, the State of the Market Assessment Framework considered features on either the demand or supply-side that may have prevented the energy market from functioning as it should. In particular, it took into consideration the five potential sources of harm below, which drew from previous reviews The Probe and RMR.<sup>17</sup>

» **Consumer engagement and response.** Ofgem's previous reviews (The Probe and RMR) identified

low levels of consumer engagement in the market and confusion surrounding tariffs, along with poor supplier behaviours.

- » **Unilateral market power.** This refers to sticky customers who are unlikely to switch, and the extent that suppliers can exploit their sticky customer base by charging them higher prices.
- » **Tactic coordination.** The degree to which the Big 6 compete with each other and whether or not they follow similar strategies to each other, and if so, the impact this has on competition.
- » **Barriers to entry and expansion.** Following consultation with smaller suppliers and potential new entrants about the barriers they have faced, they examined the extent there are barriers to entry, expansion and exit, by covering the levels of entry and growth.
- » **Vertical integration.** They examined the degree in which barriers to entry in both retail and generation exist by looking at whether independent suppliers can access wholesale energy on competitive terms; and whether independent generators can sell into those wholesale markets without being vertically integrated. Through assessing the transparency of wholesale prices, and profits.

#### 2.3.3. Findings

Elaborating on the above, and in order to assess whether harm existed in the above areas, the State of the Market Assessment gathered additional evidence and conducted analysis on the following market characteristics.

- » **Prices and profits.** The assessment reviewed company accounts from 2009 to 2012. Which **indicated that suppliers may have had an opportunity to earn high profits** based on the indicators: rising gas supply margins; relatively high target margins and possibility costs may not have been at an efficient level across the industry.
- » **Market shares.** In order to assess the degree of market power, the assessment looked at the supply of gas and electricity by retailer, which showed that while **it is possible to enter these markets** and compete with the Big 6, market share of the small suppliers has remained low over the past decade.

<sup>16</sup> State of the market report – assessment framework.

<sup>17</sup> State of the Market Assessment, Ofgem / OFT / CMA, March 2014.

Persistence  
of demand-  
side factors

» **Switching rates.** Switching rates can be an indication of a competitive market. The assessment took into consideration the speed and quality of the outcome. The assessment revealed that **switching rates have shown a falling trend since 2008**, which the report points out could be partially explained by the decline in hard doorstep selling of the Big 6.

» **Low customer trust.** Customer trust has been an on-going concern in the energy market, as such, the assessment found that **customer trust had deteriorated further** since Ofgem's RMR review in 2012, with around only 51% of customers indicating they were satisfied with their supplier and a 50% rise in customer complaints and 43% of customers not trusting their energy supplier to be open and transparent.

Related to the above, the assessment also highlighted that **low consumer engagement and weak customer pressure** remain (both of which were key themes following The Probe and RMR) important features in these markets and had become more pronounced in recent years.

» **Segmented market.** The effect of sticky customers can allow suppliers to segment and charge them higher prices than switchers. The assessment found **sticky customers** (more likely to belong to vulnerable groups) **pay higher prices** for their energy than those active and willing to switch supplier for a better deal. It is important to note, that the assessment did not look at whether these price differences were justified and reflective of the cost to serve these types of customers.

» **Barriers to entry and expansion.** The assessment spoke to a number of small suppliers and companies that had considered entering the market, who identified a number of barriers, with the most noteworthy to be, **low wholesale liquidity and heavy regulatory burden** (costs, obligations and policy changes) of the industry as the key entry deterrents.

In conclusion, the assessment found there to be **weak competition between incumbent suppliers**. Which is the result of market segmentation and possible tacit coordination. Relatedly, they also found there to be **barriers to entry and expansion** (including vertical integration) and **weak customer pressure**.<sup>18</sup>

The assessment also stated that many of the characteristics found here were identified in the 2008 Probe, and have persisted since then. It also found that some have become worse since the RMR in 2011.

For example, The Probe ruled there was no evidence to suggest the presence of collusive behaviour by the Big 6, however, the State of the Market Assessment observed various **behaviours consistent with tacit coordination**, such as large suppliers announcing price changes around the same time; increasing profitability; and large suppliers appear to rise prices faster when costs increased, compared to when they fall.

#### 2.3.4. Remedies pursued

Ofgem did not provide any remedies following the conclusion of the State of the Market Assessment, however, alongside this assessment, Ofgem published a consultation on their proposed decision to make a **market investigation reference to the CMA**, and on the 26 June 2014 referred the energy market to the CMA for full investigation,<sup>19</sup> by way of a reference for an investigation into the supply and acquisition of energy in GB. At which point the CMA began an investigation into whether there have been any market features that have an adverse effect on competition.

<sup>18</sup> State of the Market Assessment, Ofgem / OFT / CMA, March 2014.

<sup>19</sup> Decision to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain, Ofgem, 2014.



## 2.4. Energy market investigation (on-going)

### 2.4.1. The reference by Ofgem

Ofgem referred the energy market to the CMA for investigation because it considered that it would help rebuild trust and confidence in energy market and provide certainty for investment in the sector.

Figure 5. CMA Investigation Key Milestones



To reach the decision on referring the market, Ofgem considered six issues in addition to their principle objective:

- whether the features are like to endure or whether Ofgem expect existing remedies or other market developments to resolve them;
- whether the CMA could stake steps that Ofgem could not, to address persistent problems in the market;
- whether making a reference would create undue risks for security of supply by harming investor confidence;
- whether making a reference would slow or prevent progress on other regulation that is in consumers’ interests;
- whether the interests of consumers in vulnerable situations would be appropriately accommodated if Ofgem made a reference; and
- whether now is right time to make a reference, before Ofgem has seen full effect of recent reforms?

Customer response a big issue for CMA

Concluding that the relevant legal test has been passed for referring the market, and that a market investigation is in the consumers’ interests, Ofgem set out the Terms of Reference which specifies the scope of the investigation.

Generally, Ofgem kept the boundaries CMA can investigate rather broad, in order to allow the CMA to conduct a proper investigation, “*activities connected with retail and whole supply*”, however, they did restrict the CMA to investigating domestic and micro-business retail supply (i.e. not larger customers), given Ofgem had very little evidence of harmful features on those markets. In addition to the above specification, the Terms of Reference also included the regulatory framework and how it’s applied, this includes Ofgem’s role and the wider industry regulation.

### 2.4.2. The CMA’s provisional finding

The CMA is reviewing whether there are any market features that have an adverse effect on competition. If it finds this to be true, the CMA must take such action<sup>20</sup> as it considers reasonable and practicable to ‘remedy, mitigate or prevent’ the adverse effect on competition and any detrimental effects on customers. On 7 July 2015 the CMA published its provisional findings report.

The CMA found that there to be features of the relevant market prevent, restrict or distort competition in the supply of energy in the UK, and as such there are various adverse effects on competition (AEC).<sup>21</sup> In particular the CMA found the following features gave rise to AEC (focusing on the retail-related issues):

- » **Markets for domestic and microbusinesses retail supply of energy.** Features of the market act in combination (with **weak customer response**) to deter customers from engaging in the market and switching supplier. Market characteristics include:
  - the **homogeneous nature** of gas and electricity i.e. customers can’t distinguish quality of the product; and
  - role of **traditional bills**, which gives rise to a disparity between actual and estimated

<sup>20</sup> Section 138 of the Enterprise Act 2002.

<sup>21</sup> Energy market investigation – notice of findings, CMA, 2014.

consumption, which can be confusing to customers.

- » **Unilateral market power.** Suppliers in such a position (through weak customer response) have the ability to exploit it, through their pricing policies.
- » **Regulatory framework governing markets for domestic and/or SME retail energy supply.** The ‘simple choices’ reform of the RMR, which amongst other things, limits the number of tariffs suppliers are able to offer, reduces suppliers ability to innovate to meet customer demand, and softens competition between price comparison websites (PCWs). The gas settlement and the absence of a firm plan for moving to half-hourly settlement for domestic and majority of microbusinesses electricity customers, was also found to give rise to AEC.
- » **Regulatory decision making.** The lack of transparency in regulatory decision making which in turn increases the risk of poor policy decisions which have AEC. The features identified are: regulatory requirements for financial reporting; effective communication of forecasted and actual impact of policies; and Ofgem’s statutory objectives and duties.
- » **Market for retail supply of gas and electricity to SMEs specifically.** SME customers face actual and perceived barriers to accessing and assessing information arising from a lack of transparency concerning tariffs available to microbusinesses, which results in many tariffs not being published; tariffs individually negotiated between supplier and customer. Relatedly, auto-rollover tariffs and the role of TPIs also give rise to AEC.
- » **Wholesale and energy retail markets and industry code governance.** By limiting innovation and causing the energy markets to fail to keep pace with regulatory developments and other policy objectives, such as parties conflicting interests and / or limited incentives to promote and deliver policy changes; and Ofgem’s insufficient ability to influence the development and implementation phases of a code modification process.

The CMA discussed in detail the overarching feature **weak consumer response**, for both domestic and SMEs, and the supplementary **unilateral market**

**power** it gives suppliers, was a predominant feature for an AEC.

The above characteristics may be **amplified for vulnerable customers** i.e. elderly or low income earners, who the CMA, and previous reviews, have identified as being ‘sticky’ or less likely to engage, compared to other groups of customers.

In addition to the above, underlying characteristics of weak customer response is also attributable to:

- the **provision of information**, in particular, the actual and perceived barriers to accessing and assessing information arising from: (i) complexity of bill information and tariff structure; and a lack of confidence in, and access to, PCW;
- **barriers to switching**, such as when customers have uncertified meters or bad experience with transfers; and
- **PPM**, which place technical constraints on customers from fully engaging in the market.

The CMA in conjunction with the provisional findings report published a Notice of Possible Remedies which establishes and consults on possible actions which the CMA might take in order to addressing eh AEC identified above. The following section sets out possible remedies sort by the CMA.

#### 2.4.3. Possible remedies

Where the CMA finds that there is an AEC, it has a duty to decide whether it should take action itself and / or whether it should recommend others to take action to remedy, mitigate or prevent the AEC or any resulting detrimental effects on customers.<sup>22</sup> On 7<sup>th</sup> July 2015 the CMA published a Notice of Possible Remedies which sequentially sets out possible actions (if any) that the CMA might take in order to achieve its objectives. Below we set out the possible remedies that the CMA believes to effective and / or proportionate (again, focusing on the retail-related issues).

- » **Measures to address barriers to switching by domestic customers.** (i) remove of the ‘simpler choices’ component of the RMR rules from licences; (ii) removal of exemption for Centrica on two-year inspection of gas meters; (iii) energy firms prioritise the roll-out of smart meters for PPM customers; (iv) Ofgem to provide an independent price comparison service.

<sup>22</sup> Section 134(4) of the Act

- » **Measures to reduce barriers to accessing and assessing information.** (i) suppliers to provide price lists for microbusinesses; (ii) rules governing the information that TPIs are required to provide to microbusinesses; (iii) new licence requirements that prohibits auto-rollover of micro-business customers on to a new contract; and (iv) provide domestic and / or micro-business customers with different or additional information.

While weaker customer engagement across all customers groups is an important feature of AEC, vulnerable and unengaged customers is of particular concern as it can encourage unilateral market power. The CMA identifies three remedies to address these.

- » **Unengaged / 'sticky' customers.** (i) provide protection for disengaged customers from the exploitation of market power by domestic and SME retail energy suppliers; (ii) measures to prompt customers on default tariffs to engage in the market; and (iii) a transition safeguard regulated tariff for disengaged domestic and micro-business customers.

As found through the CMA's investigation, the regulatory framework which governs markets for domestic and / or SME retail energy supply, and the lack of transparency in give rise to AEC, and as such, the CMA proposes the following remedies to improve this:

- » **Regulatory framework governing domestic and SME energy retail markets.** (i) requirement to implement Project Nexus<sup>23</sup> in a timely manner; and (ii) introduction of a new licence condition on gas shippers to make monthly submissions of Annual Quantity updates mandatory.
- » **Lack of robustness and transparency in regulatory decision making.** (i) improve the current regulatory framework for financial reporting (generation and retail standalone revenues, costs and capital employed); (ii) more effective assessment of trade-offs between policy objectives and communication of impact of policies on prices and bills; (iii) revise Ofgem's statutory objectives; and (iv) introduction of a formal mechanism which disagreements between Department of Energy and Climate Change (DECC) and Ofgem over policy decision making can be addressed transparently.
- » **Industry-led system of code governance.** (i) recommendation to DECC to make code

administration and / or implementation of code changes a licensable activity; (ii) granting Ofgem more powers to project-manage and / or control timetable of the process of developing and / or implementing code changes; and (iii) appointment of an independent code adjudicator to determine which code changes should be adopted in the case of a dispute.

In its Notice of Possible Remedies, the CMA also discussed remedy options that they had contemplated, but were not considering further, however, had included the options for interested parties to provide '*evidence or reasoning*' as to why they should take those remedies into account.

Remedies considered but not pursued (at this stage) by the CMA included the following options.

- » **Price control regulation** of all domestic and micro-business retail energy tariffs i.e. imposing RPI-X on all tariffs, was later dismissed following costs and market distortion concerns (if set inappropriately).
- » Requiring energy firms to **inform customers about the cheapest tariff** on the market (across all suppliers), was precluded due to the potential consequence of sharing detailed pricing information, such as tacit coordination, and disincentives to engage effectively long term.
- » **Opt-out collective switching** of disengaged customers was not considered further due to the impacts on innovation and possible confusion and disruption for customers.
- » Introduction of a **single price for gas and electricity customers'** i.e. same price, was also not pursued following anti-competitive concerns such as increased price levels towards disengaged customers, tacit coordination, limiting competition between PCW and preventing innovation.
- » Introduction of **price non-discrimination provision** and a **transitional safeguard** regulated price structure were two options also not considered further as they was seen as not effective at achieving objectives.

<sup>23</sup> For details on Project Nexus, see <https://www.ofgem.gov.uk/publications-and->

[updates/project-nexus-strengthening-project-governance-management-and-assurance](https://www.ofgem.gov.uk/publications-and-)



#### 2.4.4. Follow up since publication

The CMA further investigated the characteristics of the pre-payment segment, namely, whether there are features of the GB markets for retail supply of energy to domestic PPM customers that gives rise to a separate AEC.

The CMA has provisionally found an AEC arising from a combination of features of the GB markets for domestic retail supply of gas and electricity to PPM customers (the PPS AEC) and published a notice of addendum to provisional findings in December 2015. The issues are as follows.

- » **Technical constraints** that limit the ability of suppliers and new entrants to innovate by offering tariff structures that meet demand from PPM customers who do not have a smart meter;
- » **Soften incentives** for all suppliers and new entrants to compete to acquire PPM customers due to: (i) actual and perceived higher costs to engage with, and acquire, PPM customers compared with other customers; and (ii) a low prospect of successfully completing the switch of indebted customers, who represent about 15% of PPM customers.
- » **Tariffs on offer to PPM are not priced at a level consistent with the competitively priced acquisition tariffs available to direct debit (DD) customers** and if they were offered, PPM customers would be able to make substantial gains from switching.

#### 2.4.5. Next steps

Following the publication of the CMA's provisional findings and possible remedies, interested parties were invited to provide views, including any suggestions for additional or alternative remedies that the wish the CMA to consider with the consultation period running between July to October 2015. The next step in the investigation are as follows:

- **March 2016:** The CMA is scheduled to publish provisional decisions on remedies;
- **April 2016:** Deadline for responses to the provisional decision on remedies;
- **Late April 2016:** Final deadline for all parties' responses before final report;
- **June 2016:** Publish final report; and
- **Late June 2016:** Revised statutory deadline.



### 3. Key themes and implications

This section of our report sets out the key themes emerging from our review. We also set out the possible implications of them for Ofwat when considering the costs and benefits of extending retail competition to household water customers in England.

This section sets out:

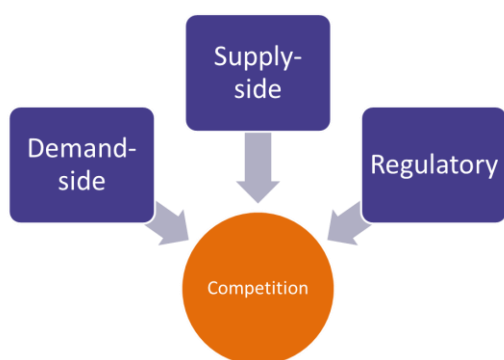
- (i) The key themes emerging from our review – in particular, the demand-side, supply-side and regulatory factors that can inhibit and enhance retail competition.
- (ii) The main issues relating to the demand-side problems that have been a “constant” throughout the competition reviews.
- (iii) The possible implications of the key themes for Ofwat’s review.

### 3.1. The demand-side, supply-side and regulatory factors that affect competition

A major theme of the four major investigations is their focus on three “categories” of factors that can affect how competitive a market is:

- **demand-side factors** such as weak customer response and lack of engagement;
- **supply-side factors** which predominately includes supplier behaviour and their pricing policies; and
- **regulatory factors**, in particular the regulatory framework governing the market in question.

Figure 6. Factors of Competition



In the following sections, we expand on the above common competition issues, and more importantly, discuss why these are relevant to delivering an effective competitive retail market.

#### 3.1.1. Demand-side factors

Consumer (and business) purchasing behaviour can have a significant impact on the effectiveness of competition. Highlighted in the previous section, the CMA found weak customer response to be a key overarching feature giving rise to an AEC in its energy retail market investigation.<sup>24</sup>

Evidence from several competition-related investigations undertaken by the CMA and its predecessors the OFT and the Competition Commission show that competition in consumer-facing services works well when consumers, here domestic and SMEs, are able to **access, assess** and **act** on information to select the service that offers the best value.

The CMA in its energy market investigation used the above concept when evaluating the effectiveness of the demand-side of the energy market, by the level of customer engagement and switching. Specifically by determining, the extent to which, consumers can:

- **access** information about the various offers available in the market;
- **assess** these offers in a well-reasoned way; and
- **act** on this information and analysis by purchasing the good or service that offers the best value.

Related to the above, the characteristics of some services, the characteristics of consumers and the decisions taken by providers, can impede their ability or willingness to access, assess and act. For example, some financial services are naturally complex or require consumers to make difficult judgements about their future circumstances (for example, a mortgage). These complexities can make it difficult for consumers to make the best decisions and, in some cases, can deter consumers from trying altogether.

#### 3.1.2. Supply-side factors

In contrast to the demand-side factors, supply-side factors relate to the capabilities and reactions of suppliers. As with demand-side factors, they can also contribute to (or impede) the effectiveness of competition in a market.

Typically when assessing of supply-side factors impacting on the effectiveness of competition within a market, the CMA and other regulatory bodies, such as Ofgem, will look at factors such as:

- **barriers to entry, expansion and exit** – the threat of new entry can act as an important competitive constraint on existing suppliers.
- **supplier behaviour** – are firms striving to out-perform each other in price, quality and / or innovation of product design?

#### 3.1.3. Regulatory factors

Lastly, regulatory factors also play a key role. Economic regulation is typically implemented to address some form of market failure, such as natural monopolies, through policies which mimic the effects of a competitive market. However, in some **instances inadequate policies are implemented, and have detrimental effects on competition in markets.**

<sup>24</sup> Energy Market Investigation: Notice of Provisional Findings, CMA, July 2015.



### 3.2. The main issues related to the demand-side factors that affect competition

A notable theme of the four major investigations is the persistence with which the demand-side issues have emerged. The investigations also highlight two-related issues, namely: that the causes of the demand-side issues matter; and regulation designed to address demand-side issues can result in unintended consequences.

#### 3.2.1. The causes of demand-side problems matter

The cause of demand-side factors can manifest themselves in many ways, in particular they can occur because of the following characteristics discussed further below.

- » **Inherent characteristics**, which refers to the features of the product / service, either actual or perceived. For example, some customers consider there to be high costs to switching energy suppliers.
- » **Supplier behaviour**, refers to the conduct by suppliers that influences customers to disengage (or engage), such as aggressive selling tactics.
- » **Combination of both**, describes a situation where suppliers, recognising the inherent characteristics or a product, and behave in a way that exploits it, such as through their pricing policies.

The causes of actual and potential demand-side problems are fundamental to the assessment of competition, as the causes will determine in part, whether it makes sense to open a market to competition and also the extent to which and how they are remedied (if this proves necessary).

**Inherent characteristics** of a product are fundamental when thinking about demand-side factors effect on competition. In effect, inherent characteristics put a limit on how much can be done to encourage customer engagement in a market. For example, it is possible that some products are simply more “engaging” than others – compare bank accounts with mobile phone services.

**Supplier behaviour can also cause changes in consumer engagement** through the way they act towards customers, which may cause them to change the way they consume the product. This could occur through the way suppliers sell, present and price their products. Poor supplier conduct, for example, can create a lack of trust in suppliers, consequently

resulting in customers not wanting to engage in the market in order to avoid dealing with them. Alternatively, suppliers can make it hard (intentionally or unintentionally) for customers to compare their product to another through the way they present their service i.e. what’s included on bill information for example.

Finally, demand-side factors could occur because of a **combination** of both demand and supply-side factors. This can occur if suppliers recognise the ‘inherent characteristics’ and accordingly, intentionally or unintentionally exploit them. For example, the CMA found suppliers to possess unilateral market power, as a result of unengaged customers and the inherent characteristics of energy (necessity good and homogenous nature), which could allow suppliers to exploit ‘sticky’ customers through their pricing policies

#### 3.2.2. Regulation designed to address demand-side problems can have unintended consequences

Attempts to correct demand-side problem can inadvertently reinforce it. This can occur where a remedy is directed towards fixing the outcome, as opposed to addressing the underlying issue.

A key issue identified in Ofgem’s RMR was that supplier behaviour and domestic customers having a lack of trust and understanding in the market, affected competition in the market i.e. a combination of supply and demand-side factors. Ofgem’s solution was to restrict, amongst others, the number of tariff choices suppliers could offer customers. However, the State of the Market Assessment found:

- falling switching rates;
- lack of customer trust in suppliers still prevailed; and
- weak customer pressure remained.

Following this, the CMA investigation also found that the ‘simple choices’ reform in the RMR limits the number of tariffs suppliers are able to offer, reduces suppliers ability to innovate to meet customer demand, and softens competition between PCWs.

This illustrates the difficulties associated with addressing the ‘*outcome*’ (tariffs), as opposed to addressing the *underlying causes* of demand-side problems (customer inertia).

### 3.3. Implications for Ofwat's review (Part 1) – emphasis on the demand-side issues

The clear implication is that in determining how competitive a household water retail market is likely to be (and hence the benefits of introducing competition), **Ofwat should place significant emphasis on understanding the likely level of customer engagement in the market.** How many customers might switch? What type of customers might switch? Will the behaviour of “switchers” protect “non-switchers”?

#### 3.3.1. Search and switching triggers

Ofwat might consider whether the water retail market might have sufficient “triggers” to encourage customers to switch. The triggers could be categorised as:

- » **Negative triggers** – for example receiving bad service from an existing supplier – such negative triggers are given by consumers as their reason for switching Personal Current Accounts.
- » **Positive triggers** – for example hearing that a friend was treated particularly well by their existing supplier – such positive triggers are given by consumers of legal services as their reason for choosing a particular lawyer.
- » **Natural triggers** – there are unrelated to relative quality of one service over another, but rather arise as a characteristics of the service – for example, the annual renewal of car insurance.

In water an obvious ‘trigger’ to prompt customers to engage in the market would be changes in price or service quality, for example a burst pipe. However, given that water prices tend to be a more stable, than say price changes in energy, it would suggest that these ‘triggers’ would occur less frequently and would require some other form of ‘trigger’ point, such as prompts on a customer’s bill or media advertising, for example.

#### 3.3.2. Search and switching information

Ofwat might also consider the likely future availability of information across three dimensions.

- » **Coverage** – whether information will be available about the offers of all suppliers or just some of them.
- » **Completeness** – whether the information will be available about all aspects of the offers, or just some of them.
- » **Ease** – how easy it will be for consumers to find the information, even if it is available.

Customer’s access to information could be assisted through the use of PCWs, either provided by Ofwat, or by third party websites. Relatedly, an important consideration when thinking about access to information, is to contemplate the different types of customers needing access to market information, in particular vulnerable customers may not have access to internet or PCWs, and as such may need access to information through alternative methods.

Relatedly, the ability and willingness of consumers to use the information they have gathered to compare one service to another and evaluate which one is best for them, is dependent on two factors:

- » **Complexity** – the extent to which the service in question is inherently complex or requires consumers to make difficult judgements about their future circumstances. This is also linked to the capability and experience of the consumers to make sense of the complexity.
- » **Comparability** – that is, the extent to which the information would be likely to allow consumers to make like-for-like comparisons across different offers.

Ofgem’s RMR found that tariff structures were hindering consumer ability to assess alternative options for their retail energy supplier due the large number; and overly complex nature of them, and as such contributed to the weak levels of customer engagement.

### 3.3.2.1. Search and switching costs

Ofwat might also consider whether switching costs could stand in the way of customer engagement.

The presence of switching costs can significantly reduce competition. Switching costs can be grouped into three categories:

- » **Financial costs** – such as the administrative costs.
- » **Time and hassle costs** – such as the time involved in filling out the forms necessary to switch, cancelling and rearranging payments.
- » **Risks** – such as the risk of the process going wrong.

These costs will be particularly important in situations where the actual or perceived benefits of switching are small.

## 3.4. Implications for Ofwat's review (Part 2) – evidence gathering

To help develop evidence in this area, Ofwat could consider using a range of **comparator retail markets**, such as the (non-household) water retail market in Scotland. Ofwat could also consider developing primary evidence using **survey and experimental techniques** (such as those used by the Financial Conduct Authority and the CMA's predecessor, the OFT). We briefly discuss these here.

### 3.4.1. Comparator retail markets

A typical starting point is to look across to other industries (as we have done here with energy), or countries, who have been through a similar regulatory reform, in order to draw meaningful inferences. In addition to looking at the energy market an obvious next step would be to look to the Scottish market, which recently opened up the retail market for NHH customers in Scotland in 2008. Evidence that would be useful to gather from Scotland would be:

- » **Switching rates** – in particular, how these have changed over time, and the drivers of switching: (i) the type of customers that are switching; (ii) marketing done to prompt switching; and (iii) switching due to price or services.
- » **Profitability** – namely the incumbents level of profits and mechanisms through which profits (if any) are generated by looking at Business Streams financial accounts.
- » **Type of services** – in particular, the services suppliers are offering, do they offer bundled

packages or offer value added services. This could be done by a review of suppliers in the market.

- » **Customer activity** – even if customers aren't switching, what are they doing, are they engaged in the market?

Additionally, other non-utility sectors such as insurance markets, could offer a useful comparison for example by assessing switching rates for personal car insurance and what is and is not working well in the sector.

Of course, in the longer-term following Ofwat's review, it would be instructive to look at the development of competition in the non-household water retail market in England.

We note that when comparing across sectors or jurisdictions, it is important to identify how and why these markets differ, as this will determine how relevant they are as comparators. For example, in Scotland, the retail market is only open for NHH customers, not households, therefore a possible comparison could be to look at smaller / micro-business customers that may consume similar levels of water to households and have other characteristics in common.

### 3.4.2. Survey and experimental techniques

Alternatively, where there are evidence gaps that can't be filled with one of the above cross-comparisons, one could conduct primary research, such as surveys or experiments.

- » **Surveys** could be useful to learn about attitudes to switching in other sectors i.e. what causes them to / not to switch, what information to people act on / take notice of, for example. Additionally, one could ask households questions about their interest in switching in the water sector.
- » **Experiments** could be conducted to see how people react and make decisions depending on the way information is presented to them. This could help Ofwat judge what types of presentation confuses / enhances decision making amongst customers.



## Further Information

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