

Project Manager
Energy market investigation
Competition and Markets Authority
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1. We write in response to the CMA's invitation to submit evidence in connection with its present investigation of the domestic retail energy sector, and in the light of its recent *Statement of Issues* of 24 July 2014.

Background

2. We write as former GB energy regulators. All of us have had executive responsibility for energy regulation – and specifically regulation of retail competition - at the highest levels in Ofgem and its predecessor bodies Ofgas and Offer. We were responsible for introducing, developing and monitoring that retail competition. Our combined executive experience covers the period from 1989 until October 2010. In addition, we are all trained economists with extensive experience of applying economics in regulatory practice, including in other regulated sectors in the UK and elsewhere.
3. In our view, the creation of retail competition in the GB energy sector was one of the great successes of energy privatisation and regulation. It meant that the tariffs and services of suppliers were better tailored to the needs of customers. It put greater competitive pressure on prices, cost of service and the purchase of power. The GB model of retail competition and its regulation was admired and copied throughout the world, including by the EU.
4. Ofgem's *Domestic Retail Market Report* of July 2007 reported vigorous price competition for all customers; innovation by suppliers in terms of fixed and capped price deals, cheaper online deals and green tariffs; improving customer service; and customer switching rates at their highest in four years.
5. We are therefore concerned by the nature of many of the views that are being expressed about the domestic retail energy market today, as reflected in the *State of the Market Assessment* of March 2014, Ofgem's reference to the CMA in June 2014 and the CMA's *Statement of Issues*. For this reason, we fully support Ofgem's decision to make a market investigation reference to the CMA. This should shed clear and independent light on what has happened over the past few years to give rise to the current situation.
6. This short note comments briefly and at high level on some of the points made in the *Statement of Issues*. We take the points in order of their appearance in that *Statement*.

The market for larger business customers

7. Para 11: “The retail supply of larger business customers was excluded from the reference on the basis that Ofgem found little evidence of harmful features in these markets.”
8. We consider that this was a sensible decision. However, the *fact* that Ofgem found little evidence of harmful features there is extremely important, and does not imply that the CMA should decline to examine these parts of the wider retail market. The obvious and immediate question is: what factors explain differences in market performance, if any differences are eventually found, between supply to larger business customers and supply to households? The question is particularly significant since factors such as liquidity, generator market power and vertical integration – considered in the *Statement of Issues* to be potential sources of harm – are common across all retail segments. If these factors are considered to be causes of harm in domestic retail markets, it needs to be explained why they are not also causes of harm in the market for larger business customers.

Regulatory intervention

9. Para 16: “Prevalence of regulation: Regulatory interventions are prevalent in both gas and electricity markets. ... detailed market rules are required to underpin liberalised wholesale energy markets.” Para 17: “ ... In gas and electricity markets, given the above characteristics, a well-functioning market will generally be expected to require some form of regulatory intervention.”
10. These statements are true, but what is at issue is the nature, extent and appropriateness of the market rules and regulatory intervention.
11. In August 2007 Ofgem announced the results of its *Supply Licence Review*, describing this as “a major undertaking involving some two years work, halving the number of licence conditions and simplification of the remaining rules to open the way for new entrants to the supply market; ... It demonstrates Ofgem’s commitment to the Government principles of Better Regulation in reducing the regulatory burden while improving protection of customers’ interests.... The Supply Licence Review is a model piece of regulation...”
12. Yet one year later, while reporting no substantive change in competitive market conditions, Ofgem’s *Energy Supply Probe - Initial Findings Report* of October 2008 proposed a different approach to the regulation of retail suppliers. It was both different in nature – for example, emphasising “the elimination of unfair price differentials” - and (increasingly over time) significantly greater in detail, scope and severity, than before 2008. It would be informative if the CMA could explore in some detail why Ofgem changed direction in this way, and assess the impact on retail competition. We expand further on these points below.

Well-functioning market

13. Para 17: “These characteristics emphasise the need for us to take a realistic approach in developing our theories of harm, and deciding on whether an AEC (Adverse Effect on Competition) exists. The benchmark against which we will assess an AEC is that of a ‘well-functioning market’, that is, one that works well for customers. For the avoidance of doubt, and as set out in our guidance, this benchmark is not based on an idealised or theoretical notion of a perfect market, but will reflect a realistic assessment of likely outcomes in the market in the absence of the AEC in question.”
14. We welcome this emphasis on a realistic approach in clarifying the benchmark against which an AEC will be assessed. In our experience, the benchmark of a perfect market is not only unattainable but also seriously misleading. Competition is appropriately seen as a rivalrous discovery process, as the Competition Commission *Guidance Notes* specified and as its former Chairs, and most recently the Chair of the CMA, have emphasised in various speeches.
15. We therefore urge the CMA not to interpret a “market that works well for customers” as licence to specify a series of features that it would be “nice to have” but that may not be feasible to achieve or that may be achievable only at disproportionate cost, or with unintended consequences that harm customers and competition. Similarly, a realistic approach to assessing effects on consumers, and behaviour of customers, implies setting aside purely theoretical and empirically unsubstantiated assumptions about how consumers might or should behave, and focusing on evidence about how they actually do behave.
16. The most obvious and realistic benchmarks for assessing potential AECs in the present domestic retail market are the same domestic market before 2008, and the GB market for larger business customers (particularly when considering wholesale market issues). These sources can be supplemented by comparisons with overseas domestic energy markets and with evidence from other GB markets such as telecommunications, insurance, financial services, etc. It might be asked, for example, whether customers are on average significantly less active (e.g. in switching suppliers) in the present GB domestic energy sector than they were in the years up to 2008, or in domestic retail energy markets in other countries, or in GB markets for other products and services.

Adapting to change

17. Paras 18, 19: “In assessing the market and considering remedies, we must also be forward thinking, recognising the changes that are currently taking place within the sector. ... we welcome views on how our analysis should take these developments into account”.
18. We agree that the market assessment and potential remedies should be forward looking, in order to respond to the various prospective changes mentioned. To

enable the market to explore and respond most effectively to such changes, we urge the CMA to allow scope for diverse actions and reactions from suppliers rather than constrain them unduly.

Effect of regulatory interventions

19. Para 57: “Hypothesis 4c: Regulatory interventions reduce the incentives for energy suppliers to compete ... We will look to assess the effect these interventions have on competition in gas and electricity markets.”
20. As noted in para 12 above, regulatory interventions in the GB domestic energy market started to take a radically different path in 2008. Questions have been raised, including by some of us, as to the appropriateness and effectiveness of a number of these interventions, but it is assessment of the general change in direction, and in particular of its causes, that is of most relevance for the future. Well-grounded and trusted regulation is of paramount importance. We therefore welcome the CMA’s intention to assess the effect of past regulatory interventions in the market.
21. Regulatory interventions can have many effects. For example, regulatory interventions to promote more consumer engagement can increase customer and supplier transactions costs, leading to lower customer benefits including via higher prices, and weaker rather than stronger competition. Regulatory interventions can also affect suppliers’ ability to compete as well as their incentives to do so. As the *State of the Market Assessment* noted (para 5.13), regulatory uncertainty, the complexity of regulation and the changing regulatory framework applied to domestic supply may act as a deterrent to new entry. The same *Assessment* also noted (para 5.16) that the recent growth of small suppliers may reflect, amongst other things, their exemption from environmental and social policy costs and the sale of 770,000 NPower customers to Telecom Plus (which was a consequence of the change in Ofgem’s regulatory policy).
22. Thus, any initial ‘theory of harm’ should not be too tightly drawn. The investigation should examine the effect of regulatory interventions on price levels and price dispersion, customer switching, customer choice and the products offered by suppliers, innovation, supplier profitability, new entry etc. We therefore welcome the implication of paragraph 21 of the *Statement of Issues* that the specification of ‘theories of harm’ will be responsive to empirical evidence and to evolving understanding of the market and of the reasons for regulatory action.
23. Because this investigation involves issues of confidence and trust in market and regulatory arrangements, it is important that the CMA’s analysis and report should be, and should be seen to be, independent of Ofgem. There are already some difficulties here. The CMA’s stated policy is that “In the case of a market investigation referred to the CMA by a regulator, some of the market study case team may be seconded to the CMA to be part of the relevant market investigation case team.” (*Market studies and market investigations: Supplemental guidance on the CMA’s approach*, CMA3, January 2014) The

State of the Market Assessment of March 2014 is a joint statement by Ofgem and the CMA (and the former OFT), which heavily reflects Ofgem's previous analyses. Of the five principal sources of evidence that the *Statement of Issues* has drawn upon (see footnote 3) no less than four are publications by Ofgem (one of which is the just-mentioned joint publication with the CMA). There is no mention, for example, of evidence from initial discussions with market participants. That evidence will no doubt be thoroughly assessed and taken into account in the CMA's ongoing work. However, given that regulatory policy is to be a significant part of this investigation, it is particularly important that the initial framing of the analysis be unbiased, and be seen to be unbiased, as between regulator, market participants and other interested parties.

Social objectives

24. Para 57: "Regulations have been imposed for a variety of reasons. Some have been introduced in an attempt to bolster elements of the competitive process, while others have been introduced to meet environmental objectives (notably, tackling climate change) and social objectives (including reducing fuel poverty). We will look to assess the effect these interventions have on competition in gas and electricity markets."
25. We welcome this intention and believe that this will be an important element of the market investigation. More specifically, we recognise the need to consider social objectives and to take full account of – and where possible ameliorate – the situations of various categories of vulnerable customers, including those in fuel poverty.
26. In this context, we recall the strong concerns voiced by older and lower income customers, in the years before 1998, about the non-availability of tariffs without standing charges. When the markets were opened to competition, suppliers responded to the needs of these customers by providing such tariffs, typically with two unit rates. Similarly, we recall the popularity, again among such customers, of E.On's Staywarm tariff, which allowed customers over 60 years of age to pay a fixed amount for their fuel, irrespective of the amount they used, spread evenly over the year. In its 14 September 2001 report to Labour Energy Minister Brian Wilson about the Social Action Plan, Ofgem highlighted this particular tariff as one of a number of major initiatives by fuel companies to address the needs of the fuel poor.
27. We understand that both types of tariff are no longer available in the market, and there is some ambiguity about how far Ofgem's new regulations are responsible. We therefore urge the CMA to investigate the reasons for the withdrawal of such tariffs, and to consider whether such outcomes are consistent with promoting competition and with meeting social objectives. We also urge the importance of measures that can improve the situations of vulnerable and fuel poor customers without compromising the competitiveness of the market and without adversely affecting other customers.

28. Finally, as noted in para 12 above, Ofgem has justified many of its competition-related policies in terms of “fairer prices”. It would be helpful to market participants, customers, those concerned with public policy generally, and not least to Ofgem itself, if the CMA were to consider whether, and if so how far, Ofgem has a statutory locus (a) to decide what are “fair” prices and (b) to impose them via licence conditions, in circumstances where such measures can be expected to affect the extent or nature of retail competition, and may benefit some customers only at the expense of others.
29. We intend this evidence to be made public. We should be happy to meet with the CMA and/or to answer any questions on it.

From:

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Sir Callum McCarthy, Chairman and Chief Executive of Ofgem and the Gas and Electricity Markets Authority (GEMA) 1998-2003

Eileen Marshall CBE, Director of Regulation and Business Affairs, Offer 1989-1994; Chief Economic Adviser and later Deputy Director General of Ofgas 1994-1999; Managing Director, Ofgem and Executive Director, GEMA 1999-2003

Stephen Smith, senior executive positions at Ofgem 1999-2002 and 2003–2010 including Managing Director, Markets, 2004-2007 and Executive Board Member, GEMA 2004- 2010

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