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Please reply to:
Sharon Darcy, Director, Sustainability First
Email: sharon.darcy@sustainabilityfirst.org.uk

Developing a framework for assessing whether conditions are in place for effective competition in domestic supply contracts: response to consultation

Sustainability First is a charity and think tank that works in the energy, water and waste sectors. We have significant experience of consumer and public interest issues, regulation and the demand side (see www.sustainabilityfirst.org.uk).

General comments

It has to be acknowledged at the outset that Ofgem faces some essential difficulties in conducting this exercise.

First, as the paper suggests (paras 4.11-14), the default tariff cap may well have had a negative impact on competition and innovation. If, on the one hand, effective competition (however defined) has developed despite the tariff cap, then there seems little point in removing it as it would continue to provide a backstop measure of protection for less engaged customers. If, however, the tariff cap has indeed had a negative impact on competition and innovation, then the tariff cap assessment must be based in part on a view that sufficient actions are in place so that removing the tariff cap would allow effective competition to develop. In the latter case, the assessment framework will need to be kept in place and used periodically to ensure that effective competition is in fact developing as predicted.

If, therefore, the framework is to be employed on more than just a one-off basis, **it is essential that the principles that guide it are future-facing** and robust to future energy market changes and the need to prepare for a **low carbon / net-zero** future. As currently written, the framework seems very much focused on the energy pricing structure and market as it is currently configured. As a result of the several current reviews into different elements of the electricity price, including reviews of charging structures[1], there could be significant changes to the structure of electricity pricing. There could be other, more radical, changes, such as a 'service', rather than a commodity, approach to energy and the need to introduce markets for heat as well as better integrating energy efficiency and flexibility services. The **framework needs to be coherent, flexible and robust enough to accommodate these potential changes** and how they affect competition and customer outcomes.

Second, it is not clear how this consultation fits with the joint BEIS / Ofgem review of energy retail markets which, as we understand, is dealing with **customers in vulnerable**

[1] This summer, Sustainability First will be publishing a Discussion Paper on 'What is Fair: How do we Pay for the Energy System of Tomorrow?'

situations. Given that **vulnerability is dynamic**, this could be potentially problematical. A clear explanation is needed of how these initiatives fit together in order to send consistent signals to investors, market actors and other stakeholders across the various pieces of work.

Third, the wider consumer context for this exercise is also important. The **Government's Consumer Green Paper** proposes that Ofgem, amongst other regulators, should develop performance metrics on consumer outcomes including price differentials. The CMA's investigation into Citizens Advice's super-complaint on the loyalty penalty in markets other than energy and the Government's response to the investigation provide a context for the likely regulatory approach to domestic energy markets as and when the tariff cap is lifted. Care will however need to be taken in applying the principles set out in the Secretary of State's letter to the CMA of 17 June 2019, in particular in relation to auto-renewal. It is necessary in energy to have a default tariff to ensure that customers can continue to have a supply even if they have not made a proactive decision about tariffs. **Auto-renewal cannot therefore be on an opt-in basis**, and prohibiting auto-renewal onto a fixed term deal would make the task of moving customers off the default tariff even more difficult.

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

In a fully competitive market for a product such as domestic electricity and gas where the quality of product does not vary between supplier, with profit-maximising suppliers and well-informed, rational customers, it should not be possible for a supplier to earn supra-normal profits from any customers against the cost base relevant to that customer, since that customer would switch to a different tariff or supplier. And, equally, predatory pricing, where a supplier charges any customer less than the appropriate costs for that customer, could not be sustained for long. It is unlikely that the domestic energy market will ever approach this degree of academic perfection. But a good measure of the effectiveness of competition in this market is **whether supra-normal profits are being earned from customers on a particular tariff, and whether there are any 'free riders'**.

"Good outcomes for most consumers" leaves open the possibility that some consumers, through no fault of their own, get a seriously bad outcome. This is unacceptable for such an essential commodity as domestic energy. It is right that protection may be needed for those least able to represent their interests, although the form of protection needs to take into account that vulnerability can be dynamic, and a simple default tariff cap may not be the answer for those who move into and out of vulnerability. But other disengaged customers also need a measure of protection against exploitation, such as supply companies making supra-normal profits at their expense.

We would also emphasise that 'Good outcomes for most consumers' needs to include long as well as short term outcomes so that the interests of future consumers are not overlooked.

Question 2: What are your views on the conditions for effective competition we have proposed? Are they clear and is there anything else you think we should take into account?

Conditions 1 and 2 can be expected in the main to benefit already engaged customers. So ensuring a good outcome for less engaged customers turns very much on Condition 3. See our comment above in answer to Question 1.

Question 3: What are your views on the structural changes that we propose to include in our framework? Are there any specific changes you think we should consider?

The structural changes mentioned seem, in principle, likely to be beneficial. However, wherever possible both these changes and other changes that may be under consideration to deal with a rapidly changing energy picture need **testing** on a sample of customers in advance of widespread implementation to ensure that in fact they do have a beneficial impact, in particular on improving engagement and customer outcomes for less engaged customers and those with vulnerabilities, and that there are no unintended consequences particularly for these latter two groups. Given the difficulties that the energy market has faced over the years, we would, therefore, encourage the piloting of more radical approaches.

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

As we argued in the introduction to this response, the assessment of effective competition needs to come in two parts:

- What evidence is there while the tariff cap is in place that effective competition will develop if the cap is lifted?
- What indicators should be used subsequently in periodic review to test that effective competition has actually developed?

The indicators of consumer behaviour and supplier performance identified by Ofgem really relate to the second of these two questions. We address them first.

It is clear that the external switching rate is an inadequate measure of disengaged customers changing tariffs, let alone an informative indicator of engagement or market health. First, it does not take into account customers who switch to a cheaper tariff with the same supplier. The second wave of Ofgem's Consumer Perceptions of the Energy Market report on 7 June 2019 found that 74% of participants were satisfied with their energy supplier, and only 21% were thinking of switching supplier. This suggests that internal switching may be at least as important a measure as switching supplier. Figure 2 of para 4.7 of Ofgem's paper now recognises that this is important.

Second, in the opposite direction, higher switching may result simply from active customers switching more frequently (as appears to be the case, for example, for those who are moving between smaller suppliers). This point is not taken into account in Ofgem's paper.

What is needed is some measure of disengaged customers becoming more engaged, for instance, the number of switches away from a default tariff or from a tariff that the customer has been on for more than, say, three years. This data may be more complicated to gather, but it should be capable of being derived from suppliers' customer records. Suppliers should be required to make this information available to Ofgem, whilst protecting individual customers' data. Where possible, this data needs to be broken down between customers with vulnerabilities and other less engaged customers. Information about the correlation between the size of a customer's bill and the level of switching would also be useful.

Third, in a world that encourages customer flexibility, some contracts may actually desirably 'lock people in for longer' – particularly if smart kit installations etc are involved. The Citizens Advice super complaint also indicates that some people see loyalty as important. These points contribute to wider concerns that switching metrics can be a poor metric of market health.

Supplier profit margin is also an inadequate indicator. Retail profit margins as a whole may be not unreasonable, but they could hide (as was the case before the imposition of the tariff cap) substantial cross-subsidy between tariff types, resulting in supra-normal profits being earned from some customers with others paying less than a fair price. At the least, profit margins on default tariffs need to be collected and assessed.

Turning to the first question, we need to be looking for some feature of the market place that would be different after the tariff cap is lifted and that is likely to encourage effective competition. The market structure indicators mentioned will certainly help. But if we are to see real change, we need to look to the market makers, ie the suppliers, to take the initiative. In general, suppliers have been very passive in their response to the tariff cap, despite the impact on their profits. If they wish the tariff cap to be removed, it would not be unreasonable to expect action from them. This need not be a collective response. Indeed, Energy UK's Future of Energy Report, whilst full of useful proposals more widely and recognising the need for all customers to be treated fairly, has nothing practical to offer in solving this problem.

Rather, this should constitute a challenge to suppliers individually to compete with new ideas to meet the needs of the new market. What the response should be should not be predetermined, but left to the imagination of individual suppliers. If adequate, the response will not just result in the tariff cap being lifted but increased market share for the successful supplier. The removal of the tariff cap could be made contingent on the development of supplier responses that demonstrably deliver positive customer outcomes in a different and/or more creative way.

Question 5: What are your views on the consumer outcomes that we propose to assess in determining whether the conditions are in place for effective competition?

Since tariffs are likely to become more complex as a result of other changes in the market, Ofgem's proposals on price and price differentials need expanding. As indicated above,

effective competition should result in no customer, through no fault of their own, getting a seriously bad outcome. This means that Ofgem will need to monitor profit margins on default tariffs to ensure that this does not occur. Distributional impacts, between larger and smaller domestic users as well as concerning vulnerability, also need monitoring.

Otherwise, the measures proposed seem appropriate. It would however be helpful to have an indication of how performance against the different measures would be balanced in the event of potential conflict.

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

No.

Sharon Darcy

Director
Sustainability First