CMA
Competition & Markets Authority

Energy market investigation

Summary of provisional decision on remedies

Notified: 10 March 2016

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The Competition and Markets Authority has excluded from this published version of the provisional decision on remedies information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by [✂].

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Summary

1. On 26 June 2014 the Gas and Electricity Markets Authority made a reference to the Competition and Markets Authority (CMA) for an investigation into the energy market in Great Britain.[1] The terms of reference for this investigation allow us to look at any competition issue connected with the supply or acquisition of gas and electricity in Great Britain, including both retail and wholesale markets, except that, in the case of retail markets, only the retail supply of households and microbusinesses are included within the reference.

2. In the provisional findings report, published in July 2015, and the addendum to provisional findings, published in December 2015, we provisionally found that there are features of the markets for the supply of energy in Great Britain that result in an adverse effect on competition (AEC).[2]

3. Where we find that there is an AEC, we have a duty to decide whether we should take action ourselves and/or whether we should recommend others to take action to remedy, mitigate or prevent the AEC or any resulting detrimental effects on customers. In deciding these questions we have a duty to achieve as comprehensive a solution as is reasonable and practicable to the AEC and any resulting detrimental effects on customers.

4. This document sets out our provisional decision on remedies from this investigation.

Wholesale electricity market remedies

5. The wholesale price of electricity represents just under half the total cost of supplying electricity to domestic customers, and it is therefore vital, in the interests of ensuring that the overall prices paid by customers are competitive, to ensure that competition operates well in the wholesale market.

6. In our provisional findings report, we provisionally found that two aspects of the regulatory regime governing wholesale market operation led to AECs:

   (a) the mechanisms for allocating Contracts for Difference (CfDs); and

   (b) the absence of locational charging for transmission losses.

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[1] Energy market investigation terms of reference.
[2] This is defined in section 134(2) of the Enterprise Act 2002.

Allocation of Contracts for Difference

7. In our provisional findings report we welcomed the introduction of CfDs as the main mechanism for incentivising investment in low carbon generation, partly because, by enabling a competitive process to set the level of subsidy to low carbon generators, CfDs should provide a more efficient means of providing support.

8. However, we expressed a concern that some elements of the CfD allocation process currently in place potentially restrict the use of competition in setting the level of support, which could result in higher bills for customers. Notably, the Energy Act 2013 gives the Department of Energy & Climate Change (DECC) powers to award CfDs directly to parties through a non-competitive process in the future. We therefore provisionally found that the mechanisms for allocating CfDs give rise to an AEC due to the absence of an obligation for DECC to:

   (a) carry out, and disclose the outcome of, a clear and thorough impact assessment supporting a proposal to use its powers to allocate CfDs outside a competitive process; and

   (b) monitor the division of technologies between different pots, which form the basis of CfD auctions, and provide a clear justification when deciding on the allocation of budgets between the pots for each auction.

9. The government is set to invest billions of pounds in decarbonising electricity generation over the next few years. The spending cap under the Levy Control Framework – which covers the Renewables Obligation (RO), Feed-in Tariffs and CfDs – will rise to £7.6 billion for the period 2020/21.

10. With such large sums of money at stake, suboptimal regulatory design can lead to substantial customer detriment. Indeed, we estimate that the cost of supporting an early form of CfDs (under the FIDeR framework[3]) allocated outside the context of a competitive auction is £250–£310 million per year higher than it likely would have been had the FIDeR projects been awarded CfDs through a competitive auction. This is roughly equivalent to 1% of all customers' electricity bills.

11. This evidence illustrates the significant impacts that DECC's decisions in this area can have on the costs faced by energy customers. It is essential, therefore, when DECC makes such decisions in the future, that they are based on rigorous analysis, and that the impacts are communicated in a

[3] The Final Investment Decision enabling for Renewables scheme.

clear and transparent manner. We believe our remedies will help ensure that this happens.

DECC to undertake and consult on an impact assessment before awarding CfDs outside the auction mechanism

12. The aim of this proposed remedy is to ensure that, in the future, if DECC is considering allocating a CfD outside the competitive auction process, it undertakes a clear and rigorous analysis of the impact of doing so and consults on this basis before reaching a final decision.

13. We note that, in principle, there may be circumstances under which allocating CfDs outside the competitive auction process could result in lower costs to customers. For example, there may be cheap projects with a lifespan and other operating characteristics that are so different to the characteristics of potentially competing projects that it is difficult to compare them within an auction framework. Since an element of judgement will be required in making these assessments we have not considered it appropriate to recommend imposing absolute rules determining the situations in which non-competitive allocation would be allowed.

14. Before deciding to allocate support on a non-competitive basis, however, we recommend that DECC set out clearly in an impact assessment why it considers that it is not feasible for the project to compete in the competitive auction process and why the benefits to customers of non-competitive allocation are likely to exceed the costs.[4]

15. We recommend that DECC consult on the basis of impact assessments at two stages: before entering into negotiations with prospective generators, in order to identify the possible costs and the benefits that may arise from supporting a given technology; and after the negotiations with prospective generators and the provisional agreement of a strike price, to expose the specific impacts on customers expected to arise from the proposed contract.

DECC to undertake and consult on an impact assessment before allocating technologies between 'pots' and the CfD budget to the different pots

16. In allocating CfDs on a competitive basis, DECC separates technology into separate 'pots', to which it assigns separate budgets. Since only technologies within the same pot compete against each other, decisions on

[4] We note that no such assessment was carried out in relation to the FIDeR projects. If any such assessment had been carried out, we do not believe that it would have led to the conclusion that it was in customers' interests to allocate the FIDeR projects outside of the auction.

these parameters influence the intensity of competition and the level of support provided through the scheme.

17. We recommend that DECC undertake an impact assessment and consult before allocating technologies between pots and the CfD budget to the different pots. As part of its analysis and consultation, DECC should estimate the extent to which the short-run costs of supporting low carbon generation are affected by its decision. This can then be weighed against any long-run benefits (eg cost reductions of future projects), to assess overall impacts on customers.

18. We recommend that DECC should undertake an assessment of the appropriate allocation of technologies and budgets to pots prior to each CfD auction and consult on this basis. To ensure that potential bidders are able to make informed decisions about whether to progress a project in advance of the auction, DECC should finalise its proposals for the allocation of technologies and budgets at least one year ahead of the auction.

Locational adjustments for transmission losses

19. Energy is lost when electricity is transported from one part of the country to another, and the greater the distance travelled, the higher the losses. The costs of these transmission losses therefore vary considerably by geographical location – in an area with relatively low levels of demand and high levels of generation, for example, consuming electricity will be associated with low losses and generating electricity will be associated with high losses. However, despite this locational variation in the costs of losses, under the current regulatory regime, these costs are allocated to generators and customers in a way that takes no account of their geographical location.

20. We have provisionally found that the absence of locational pricing for transmission losses is a feature of the wholesale electricity market in Great Britain that gives rise to an AEC, as it is likely to distort competition between generators, raise bills to customers and to have both short- and long-run effects on generation and demand:

    (a) In the short run, costs will be higher than would otherwise be the case, because cross-subsidisation will lead to some plants generating when it would be less costly for them not to generate, and other plants, which it would be more efficient to use, not generating.

    (b) In the long run, the absence of locational pricing may lead to inefficient investment in generation, including inefficient decisions over the

extension or closure of plant. There could also be inefficiency in the location of demand.

21. Our proposed remedy is to require that variable transmission losses are priced on the basis of location, and to assign 100% of losses to generators, rather than 45% as under current charging arrangements.

22. We have conducted a modelling exercise to assess the benefits that might be expected to arise from the introduction of locational charges for losses. The model results suggest that the total cost of meeting the electricity demand of customers in Great Britain will fall by between £158 million and £190 million over the period 2017 to 2026 due to the proposed remedy, depending on the future level of fossil fuel prices. The additional efficiency gain of requiring generators to bear 100% of transmission losses is estimated to be worth between £14 million and £31 million. The model also estimates that there will be a moderate additional environmental benefit from the reduction in SO2 and NOX emissions from the proposed remedy, valued at between £0.4 million and £14.4 million over the period.

23. The results of our modelling are similar, overall, to those from previous modelling exercises conducted in support of previous proposals to introduce locational charging for transmission losses. We have not attempted to model the dynamic benefits from the proposed remedy, in terms of more efficient investment, due to the complications and uncertainties of such modelling. All in all, expected benefits from the remedy – considering both benefits we have modelled and those we have not – exceed by far expected implementation costs, which are less than £10 million.

24. In summary, based on the modelling work we have conducted and other analysis, our provisional conclusion is that introducing locational charging for transmission losses will reduce costs and be in the long-term interests of customers. We propose to implement the remedy by means of an order imposed on National Grid, as system operator, to calculate imbalance charges taking into account transmission losses calculated on a locational basis and according to which 100% of losses would be borne by generators.

Updated assessment of AECs and detriment affecting domestic customers

25. In our provisional findings report, we provisionally found four AECs concerning domestic retail energy markets. We provisionally found: one AEC relating to weak customer response (the Domestic Weak Customer Response AEC); and three AECs relating to aspects of the regulatory framework – the electricity and gas settlement systems and elements of the ‘simpler choices’ component of the Retail Market Reform (RMR) rules.

26. In addition, in the addendum to provisional findings we set out features that in our provisional view give rise to a fifth AEC in the domestic retail markets, relating specifically to prepayment customers (the Prepayment AEC). We provisionally found that these features, in combination, reduce retail suppliers' incentives (and, for some, their ability) to compete to acquire prepayment meter customers (in particular, customers with an outstanding debt or a poor credit history) and to offer tariffs that meet customers' demand. As a result, the tariffs available in the prepayment meter segments are not competitively priced compared with the direct debit segments.

27. We have conducted updated analysis of the relative strength of these provisional AECs and the features contributing to them, including: an update of analysis of the gains available to customers from switching; an updated analysis of the provisional AECs and features affecting customers on prepayment meters; and an analysis of the provisional AECs and features affecting customers on restricted meters.

Updated analysis of gains from switching

28. In the provisional findings report, we reviewed a number of pieces of evidence that showed that domestic customers exhibited weak customer response, including: our customer survey, in which 34% of respondents said they had never considered switching; the numbers of customers on default tariffs; and the existence of material, persistent gains from switching supplier, tariff and/or payment method that go unexploited by such customers.

29. We have updated our gains from switching analysis, extending the period of the analysis from Q1 2012 to Q2 2015, extending the calculations of annual potential savings to customers of the four Mid-tier Suppliers[5] and making certain methodological improvements.

30. The gains available to customers differ quite substantially according to the scenario chosen and category of customer concerned (and in particular, the supplier they are with, the type of tariff they are on and the payment method they employ). Overall, the results demonstrate that:

    (a) there were material, persistent savings available to customers of the Six Large Energy Firms[6] over the period;

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[5] Co-operative Energy, First Utility, Ovo Energy and Utility Warehouse.
[6] The Six Large Energy Firms are Centrica plc (Centrica), EDF Energy plc (EDF Energy), E.ON UK plc (E.ON), RWE npower plc (RWE), Scottish and Southern Energy plc (SSE) and Scottish Power. These firms are the former monopoly suppliers of gas (Centrica) and electricity (EDF Energy, E.ON, RWE, SSE and Scottish Power) to GB customers.

(b) the savings available to customers on standard variable tariffs were, on average, larger than savings available to non-standard tariff customers; and

(c) the savings available to standard credit customers were, on average, higher than those available to customers on other payment methods.

31. We also note that the savings available to customers on prepayment meters were, on average, substantially lower than those available to other customers, reflecting the more restricted range of tariffs available to them. This is discussed further below.

32. The table below shows average period results for the domestic customers of the Six Large Energy Firms under the most liberal scenario for customer choice (scenario 5x).[7] Overall, we calculated that the weighted average gains to all the dual fuel customers of the Six Large Energy Firms over the entire period was £164 under this scenario.

Table1: Weighted average savings under scenario 5x for domestic customers of the Six Large Energy Firms on different tariffs and payment methods, Q1 2012 to Q2 2015

Dual or single fuel	*Tariff type*	*Payment type*	*Average savings (£)*	*Average savings (%)*
Dual	Non-standard	All	109	9
Dual	SVT	Direct debit	205	16
Dual	SVT	Standard credit	245	23
Dual	SVT	Prepayment	70	8
Single gas	Non-standard	All	96	14
Single gas	SVT	Direct debit	132	19
Single gas	SVT	Standard credit	142	24
Single gas	SVT	Prepayment	48	13
Single electricity	Non-standard	All	55	9
Single electricity	SVT	Direct debit	95	15
Single electricity	SVT	Standard credit	118	23
Single electricity	SVT	Prepayment	45	8

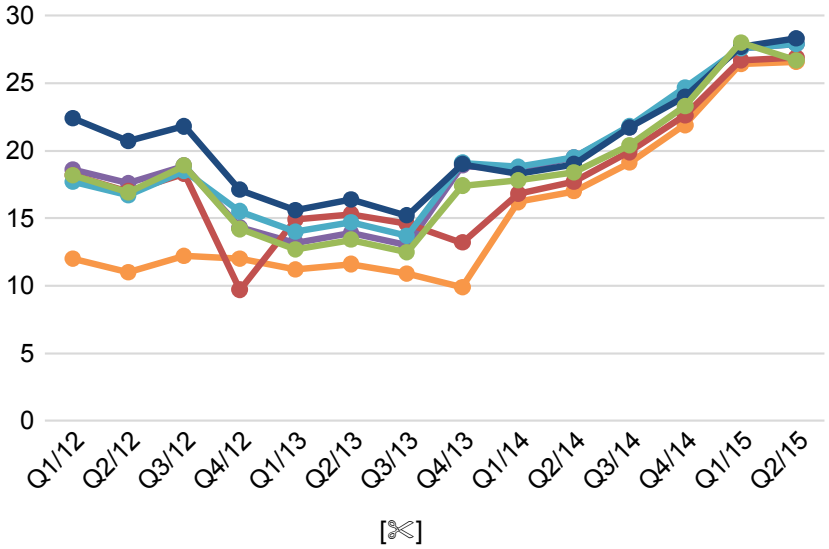
Source: CMA analysis. Scenario 5x.
Note: SVT = standard variable tariff.

33. We have also assessed how the potential savings to customers have evolved over time. The figure below shows the annual potential savings from switching (% of the bill) available to the dual fuel standard variable tariff customers (excluding those on prepayment meters) of each of the Six Large Energy Firms over time under scenario 5x. It shows that annual potential savings for these customers have risen substantially over the past two years, and have reached their highest level in the most recent period of the

[7] In this scenario, customers are able to switch supplier, tariff, payment method (except for prepayment customers, reflecting the greater barriers they face in using other payment methods), and gains are reduced to reflect the exit fees a customer may incur in moving from a non-standard tariff. Appendix 3.2 presents the results of a broad range of scenarios, which differ according to the parameters of choice available to the customer.

analysis, Q2 2015, reaching an equivalent of between £310 and £360. There is a similar trend for the standard variable tariff customers of the Mid-tier Suppliers, although there is a bigger disparity in the positions of individual suppliers.

Figure 1: Weighted average potential savings (% of bill) available to the dual fuel SVT customers (excluding prepayment) of the Six Large Energy Firms under scenario 5x



Source: CMA analysis.
Notes:
1. Within each quarter the weighted average is calculated using data on the distribution of consumption and the weights reflect the number of accounts that belong to each tariff.
2. Base: all dual fuel SVT customers (excluding prepayment).

34. We note that in February 2016, the Six Large Energy Firms announced a reduction in the price of their standard variable gas tariffs, ranging from 5 to 5.4%, and expected to come into effect from February to March 2016.[8] However, we do not believe this will materially change the pattern of results seen in the chart above. Indeed, gains may even have increased further, since we would expect the acquisition tariffs to follow more closely the reduction in wholesale gas and electricity prices, which comprise roughly 50% of the total costs incurred in supplying gas and electricity and have fallen around 33% and 20% since Q2 2015, respectively.

Customers on prepayment meters

35. The proportion of customers on prepayment meters has increased steadily over the last 20 years, from 7% in 1996 to 16% currently. Unlike the choice of whether to pay by direct debit or standard credit, prepayment is not

[8] EDF Energy announced a price cut of 5%; British Gas announced a price cut of 5.1%; E.ON announced a price cut of 5.1%; RWE npower announced a price cut of 5.2%; SSE announced a price cut of 5.3% and Scottish Power announced a price cut of 5.4%.

generally a choice on the part of the customer. Prepayment meters are generally installed where a customer has had a poor payment history or in certain types of accommodation such as student accommodation. Nearly all prepayment customers are on standard variable tariffs, reflecting the limited choice of non-standard tariffs they face.

36. In our addendum to provisional findings, we identified particular supply-side constraints affecting customers on 'dumb' (ie non-smart) prepayment meters and which limit the extent of competition in the segments. These constraints, arising from the dumb prepayment infrastructure, take the form of limitations on the numbers of tariffs that suppliers can offer due to the limited number of gas and electricity tariff 'slots'. We found these constraints to be particularly binding for new entrants in gas on account of the low availability of gas tariff slots – over 85% of which were held by the Six Large Energy Firms, including a large proportion that they were not using.

37. We also provisionally found softened incentives for all suppliers, and in particular new entrants, to compete to acquire all prepayment customers, whether on smart or dumb prepayment meters. This was due to actual and perceived higher costs to engage with, and acquire, these customers compared with other customers, and the low prospect of successfully completing the switch of indebted customers (who represent about 15% of prepayment customers).

38. Our provisional analysis of the prepayment segments suggested that competition is significantly weaker than in the wider GB domestic retail energy markets. We found that entry and expansion by suppliers other than the Six Large Energy Firms in the prepayment segments is slower, and that entry is limited to fewer suppliers, than we have observed in the broader domestic markets. We also found that the range of tariffs available to prepayment customers is significantly more limited than those available in the credit meter segments, and that the cheapest tariffs that are offered by suppliers to prepayment customers are significantly higher (even accounting for differentials in the costs to serve) than the cheapest tariffs in the direct debit segments.

39. We have examined more recent data to assess, as was put to us by some of the respondents, whether competition in the prepayment segments has recently intensified.

40. We first looked at our extended gains from switching data set which covers the period from Q1 2012 to Q2 2015. We observed that the gains from switching available to dual fuel customers on prepayment meters have been fairly static, with gains available as of Q2 2015 of between £70 and £120,

depending on the customer's supplier. This is in contrast with a sharp increase in the gains available to prepayment customers if they were to switch to a credit meter, which doubled between 2013 and 2015, reaching between £290 and £370 as of Q2 2015, depending on the supplier.

41. We also conducted a search on a price comparison website (PCW) in order to look at the most recent pricing data. We found that, as of 1 March 2016, there were large differences between the cheapest prepayment and direct debit tariffs, between £260 and £330, depending on the region. This is well in excess of our estimate of the cost differential between the two payment methods of £54.

42. We also looked at the customer numbers in the prepayment segments, and how they changed over time, for both the independent suppliers and the Six Large Energy Firms. We observed an increase in the share of independent suppliers in the prepayment segments over time, reaching 8% for gas and 7% for electricity as of Q2 2015.

43. Overall, while there has been an increase in the share of independent suppliers, we have seen no evidence of improving outcomes for prepayment customers relative to the position we documented in the addendum to provisional findings.

44. We have also reviewed the available evidence on the extent to which the Domestic Weak Customer Response AEC applies to customers on prepayment meters. The evidence suggests that a higher proportion of prepayment customers are less engaged than direct debit customers (but not less engaged than standard credit customers), particularly in terms of whether they have ever considered switching or are likely to consider switching in the next three years, and their awareness of their ability to switch.

45. There are a number of factors that may explain this:

    (a) Prepayment customers face particular restrictions on accessing and assessing information about switching (including relatively low access to the internet and confidence in using PCWs).

    (b) Prepayment customers include higher proportions of individuals: with low levels of income; with low levels of education; living in social rented housing; and having a disability – demographic characteristics that we have found to be associated with low levels of engagement in retail energy markets.

(c) While the need to top up prepayment cards regularly is likely to increase awareness of retail energy markets among prepayment customers, low levels of engagement may have in part been influenced by the outcomes we have observed arising from the Prepayment AEC – notably the lower gains from switching and the confusion surrounding rights to switch when the customer has outstanding debt.

46. The overall weight of evidence supports a provisional finding that disengagement and weak customer response is a more significant problem among prepayment customers compared with domestic customers on direct debit.

Customers on restricted meters

47. Restricted meters include any metering arrangement whereby a domestic customer's consumption at certain times and, in some cases, for certain purposes (for example, heating) is separately recorded. These meters allow for customers to be charged lower rates for electricity used at times when overall demand is lower.

48. There are currently over 4 million restricted meters (around 17% of all customer accounts) of which around 700,000 (about 2% of all customer accounts) are non-Economy 7 restricted meters.[9] Our analysis has focused on the position of non-Economy 7 restricted meters, about which we have heard specific concerns (and henceforth refer to this group as 'customers on restricted meters' unless otherwise specified).

49. Our further analysis shows that customers on restricted meters face particularly strong barriers to accessing and assessing information and barriers to switching supplier and/or tariff.

50. As regards facing specific barriers to accessing and assessing information, we have found that this is partly because restricted meter tariffs are not supported by PCWs or suppliers' online search tools. As regards facing barriers to switching supplier and/or tariff, we have been told that many restricted meter customers do not have a choice of supplier offering bespoke tariffs. They can in principle switch to a single-rate or an Economy 7 tariff offered by their supplier or rival suppliers, but some suppliers would require their existing meter to be replaced at a cost to the customer and loss of functionality. Changing meters might also involve some rewiring in the home.

[9] Economy 7 customers are included in our assessment of gains from switching discussed above.

51. All this means that, for customers on restricted meters, understanding the options available to them and switching supplier is substantially more difficult than it is for customers on other meter types. Reflecting this, we have found that, across Great Britain the historical incumbent supplier's share of supply in restricted meters is 79% which is significantly higher than the equivalent figure for all electricity (33%) and gas (37%) customers. For certain types of restricted meter, the incumbent supplier still supplies nearly 100% of customers on these meters.

52. Despite the cost advantages to suppliers of serving customers on restricted meters, we have found, using data from Q2 2015, that 69% of customers on restricted meters would have had lower bills if they were on the cheapest single-rate tariffs available on the market and that those who could have saved would have saved an amount equivalent to around 18% of their bill. We note that the results differ significantly depending on the supplier in question – for two of the Six Large Energy Firms, over 85% of their customers would have been better off on the cheapest single-rate tariff.

Updated analysis of detriment

53. To assist us in deciding on appropriate remedies, we have assessed the nature and extent of detrimental effects on domestic energy customers resulting from the AECs that we have provisionally identified.

54. Our approach to assessing the scale of detriment is to consider to what extent the outcomes that we have observed in the retail energy markets are worse than we would expect to see in well-functioning competitive markets, including the extent to which domestic energy customers are, on average, paying higher prices than they would do in well-functioning competitive markets and receiving poorer quality of service. Most of our analysis has focused on the first source of detriment – excessive prices – since we believe that this is likely to be the most significant form of detriment suffered by energy customers, given the homogenous nature of gas and electricity.

55. We have adopted two approaches to assessing the extent to which prices have exceeded those we would expect in a well-functioning market:

(a) a 'direct' approach, which involves comparing the average prices charged by different suppliers, while controlling for those differences in each supplier's customer base that are likely to affect costs; and

(b) an indirect approach, which involves assessing both:

(i) suppliers' levels of profitability (and in particular whether the Return on Capital Employed by suppliers exceeds their cost of capital); and

(ii) the extent to which suppliers have incurred costs inefficiently (ie whether costs are higher than we estimate an efficient supplier would incur).

56. The benefit of the direct approach is that it gives us a more direct measure of customer detriment based on actual market prices – and prices are ultimately what matter to a customer, rather than a supplier's level of profitability or cost efficiency. Further, the direct approach allows for a much more granular breakdown of detriment, not just by supplier but by customer type, including type of tariff and payment method.

57. The indirect approach provides information on profitability and cost efficiency which can be a useful proxy for customer detriment. It can therefore provide a useful independent cross check on our direct analysis, as it is based on a separate data set and methodology.

Direct approach

58. Our direct approach to assessing detriment involves calculating the average prices offered by different suppliers to their customers and comparing these to a 'competitive benchmark price', which is constructed as the average prices offered by the most competitive suppliers. In making this comparison, we adjusted for exogenous cost differences relating to network costs and the costs associated with different payment methods, to ensure the comparison is on a broad like-for-like basis.

59. Using this approach, we estimated the detriment from excessive prices to the domestic customers of the Six Large Energy Firms to be about £1.7 billion a year on average over 2012 to 2015, the entire period for which we had data, with a marked trend upwards year on year, reaching almost £2.5 billion in 2015. We consider this our headline estimate of the annual detriment arising from high domestic retail market prices.

60. We have also considered the extent to which the scale of excessive pricing by the Six Large Energy Firms varies between different payment methods. This is shown in the table below.

Table 2: Detriment of the domestic customers of the Six Large Energy Firms by customer category and fuel type, Q1 2012 to Q2 2015

Dual or single fuel	*Direct debit (% of bill)*	*Standard credit (% of bill)*	*Prepayment (% of bill)*	*All (% of bill)*
Dual fuel	10%	11%	15%	11%
Single fuel electricity	9%	11%	13%	10%
Single fuel gas	18%	16%	17%	17%

Source: CMA analysis. Analysis based on Ofgem's medium Typical Domestic Consumption Values. Bills are calculated net of network costs and adjusted for the costs of different payment methods.

61. For dual fuel customers (the majority of all the customers of the Six Large Energy Firms) and single fuel electricity customers (31% of their electricity customers), we found that the detriment across all of the Six Large Energy Firms is biggest for prepayment customers, followed by standard credit customers and then direct debit customers. We found no such difference for single fuel gas (19% of their gas customers), though we note that the observed detriment overall is higher for single fuel gas than for dual fuel and single fuel electricity customers.

62. We also note that there is considerable variation (both within the Six Large Energy Firms and the Mid-tier Suppliers) in the extent to which individual suppliers price above the competitive level. For the Six Large Energy Firms, for example, average detriment experienced by their dual fuel customers over the period ranges from between 5% and 13% of the bill depending on the supplier. At this stage we have not identified the suppliers concerned in order to give parties the opportunity to respond to our analysis first. We intend to do so in our final report.

Indirect approach

63. We have also estimated customer detriment from excessive prices indirectly from the financial results of the Six Large Energy Firms which involved assessing both suppliers' level of profitability and the extent to which suppliers have incurred costs inefficiently.

64. The analysis using the indirect approach yields a total estimate of customer detriment from excessive prices of between £660 million and £1.1 billion a year, depending on the choice of the efficiency benchmark. There are a number of reasons why the indirect approach gives a lower estimate of detriment than the direct approach, including that the indirect approach covers a longer time span which includes two years when several of the Six Large Energy Firms made losses, and that the indirect approach takes a conservative approach to identifying the level of economic profits made and the efficient indirect cost base of the Six Large Energy Firms. It also does not seek to identify the efficient level of wholesale energy costs.

65. Overall, we place greater weight on the direct approach, as it is a more relevant and granular measure of domestic customer detriment. We note, however, that detriment calculated under this approach is far in excess of the net profits earned by the Six Large Energy Firms from their sales to domestic customers (eg assessed detriment in 2014 is almost double the Earnings Before Interest and Tax from domestic sales of the Six Large Energy Firms in 2014). The implication is that there is a high degree of inefficiency in current prices.

Quality of service and innovation

66. In relation to quality of service, we observed that there are several metrics which suggest that energy customers receive a poorer quality of service from the Six Large Energy Firms than they would do in well-functioning competitive markets. Those include the data which shows that the smaller suppliers have achieved consistently higher net promoter scores than the Six Large Energy Firms, and that there has been a marked increase in recorded customer complaints since 2008 and 2013 which resulted in a number of enforcement actions brought by Ofgem against the Six Large Energy Firms.

67. We have also found that some regulatory interventions, in particular the recent RMR rules, have served to reduce innovation in recent years, and that the absence of an accurate settlement system has inhibited the development of time-of-use tariffs which could bring substantial benefits in terms of reduced costs.

Summary

68. Overall, we consider there to be a material customer detriment arising from the provisional AECs that we have identified in retail energy markets. We estimated that the customer detriment associated with high prices was about £1.7 billion a year on average for the period 2012 to 2015 with a marked upwards trend. We also found evidence which is indicative of harm to customers from poor quality of service and restrictions on innovation, but by its nature this type of harm is less readily quantifiable.

Domestic retail remedies

69. We have drawn on the above analysis in developing our remedies and in assessing the proportionality and effectiveness of the package of remedies as a whole. At a high level, our proposed package of remedies for domestic customers comprises three strategic components:

(a) creating a framework for effective competition;

(b) helping customers to engage to exploit the benefits of competition; and

(c) protecting customers who are less able to engage to exploit the benefits of competition.

Creating a framework for effective competition

70. If competition in retail energy markets is to serve customers' interests, it is vital that the regulatory and technical framework allows suppliers to compete effectively. Provided customers are sufficiently engaged, this will help drive down prices and improve quality of service.

71. We have identified a number of aspects of the regulatory framework that we believe undermine effective and efficient competition and propose three categories of remedy that we believe will help improve this framework:

(a) the withdrawal of the simpler choices component of the RMR;

(b) reform of the settlement systems for gas and electricity; and

(c) measures to address the technical and regulatory constraints impeding competition for prepayment meter customers.

Withdrawal of the simpler choices component of the RMR rules

72. In the provisional findings report we set out evidence on the impact that the 'simpler choices component' of the RMR rules has had on the ability and incentives of suppliers to compete on the range of tariffs and discounts offered to domestic customers. We also consider that the simpler choices component of RMR rules (in particular the four-tariff rule) limits the scope for competition between PCWs for customers switching energy suppliers to exert downward pressure on energy prices.

73. We are therefore proposing a remedy, the aim of which is to:

(a) promote competition and innovation between retail energy suppliers in the retention and acquisition of domestic customers by allowing them to offer a wider range of tariffs than permitted by the 'simpler choices' component of the RMR rules, including tariffs designed to appeal to certain customer groups; and

(b) facilitate competition between PCWs by allowing them to negotiate exclusive tariffs with domestic energy suppliers and to offer discounts funded by the commissions they receive from suppliers.

74. The proposed remedy takes the form of a recommendation to Ofgem to remove a number of standard licence conditions relating to the simpler choices component of the RMR rules. These include: the ban on complex tariffs; the four-tariff rule; the ban on certain discounts; and the ban on certain bundled products.

Settlement reform

75. Energy suppliers generally attempt to purchase in advance the electricity and gas that they expect their customers to consume, to help them manage price and volume risks. But both gas and electricity demand are driven by a range of factors that are difficult to predict accurately, such that there will always be some disparity between the volumes of energy covered by suppliers' contracts and the volumes their customers actually use in real time. Settlement is the system by which such disparities are identified, reconciled and paid for.

76. Accurate and timely settlement is fundamental to well-functioning retail energy markets, since without this, suppliers will not have the right incentives to minimise the overall costs of energy – which are ultimately borne by customers. However, in our provisional findings report we expressed concerns that elements of the settlement systems of both gas and electricity lead to inaccuracies and delays that distort competition between energy suppliers.

Electricity settlement reform

77. Electricity settlement takes place every half hour but the majority of domestic and microbusiness customers do not have meters capable of recording half-hourly consumption. Therefore, their consumption must be estimated on an ex ante basis. This is done by assigning customers to one of eight profile classes, which are used to estimate a profile of consumption over time and allocate energy used to each half-hour period.

78. Our main concern in relation to electricity settlement is that such estimates fail to charge suppliers for the true cost of their customers' consumption. This means that suppliers are not incentivised to encourage their customers to change their consumption patterns, as the supplier will be charged in accordance with their customers' profile regardless of their actual consumption behaviour. This in turn distorts suppliers' incentives to innovate and bring in new products and services such as time-of-use tariffs, which reward customers for shifting consumption away from peak periods. Further, the Smart Energy Code currently prohibits suppliers from collecting consumption data with greater than daily granularity unless a customer has

given explicit consent to do so. We believe that this opt-in clause is a major barrier to the development of static and dynamic time-of-use tariffs.

79. Our proposed remedy package in relation to electricity settlement comprises recommendations: to DECC to consult on amending the provisions of the Smart Energy Code; to Ofgem that it conduct a full cost-benefit analysis of the move to mandatory half-hourly settlement and consider options for reducing the costs of elective half-hourly settlement; and to DECC and Ofgem that they publish and consult jointly on a plan setting out timescales and responsibilities relating to the introduction of half-hourly settlement.

Gas settlement reform

80. Our concern in relation to the current system of gas settlement is that it leads to an inefficient allocation of costs to parties and creates scope for gaming, which reduces the efficiency and, therefore, the competitiveness of domestic retail gas supply.

81. We note that a modification process currently underway – Project Nexus – is likely to address most of the current inefficiencies in the gas settlement system. However, we were concerned that even after implementation of Project Nexus, the gas settlement process would still be characterised by the presence of a (residual) amount of unidentified gas, inefficiencies in the allocation of the cost of this residual unidentified gas, as well as incentives that shippers face to place a higher priority on adjusting Annual Quantities (AQs) down.

82. Our proposed remedies in relation to gas settlement comprise: a recommendation to Ofgem to ensure implementation of Project Nexus by 1 October 2016; an order on gas suppliers to submit all meter readings for non-daily metered supply points in Great Britain to Xoserve as soon as they become available and at least once a year, except for smart meters where meter readings must be submitted monthly; and a recommendation to Ofgem to take responsibility for the development and delivery of a performance assurance framework concerning unidentified gas as soon as reasonably practicable.

Remedies to address constraints on competition for prepayment customers

83. In addition, we believe that there are features of the domestic retail energy markets that give rise to two distinct, but related, AECs concerning prepayment meter customers: one on the demand side (the Domestic Weak Customer Response AEC); and one principally concerning the supply side (the Prepayment AEC).

84. In relation to the constraints imposed by the dumb prepayment infrastructure, we are proposing a range of remedies that will make better use of the available tariff slots, so as to reduce the impact of the dumb prepayment meter technical constraints on the ability of suppliers, and in particular new entrants, to innovate by offering tariff structures that meet demand from prepayment meter customers who do not have a smart meter.

85. The proposed remedies include recommendations to Ofgem that it: take responsibility for the efficient allocation of gas tariff pages; and, if necessary, change gas suppliers' standard licence conditions to impose a cap on the number of gas tariff pages that any supplier can hold and to enable Ofgem to mandate the transfer of gas tariff codes to another supplier.

86. To further mitigate the impact of tariff codes on competition for customers on dumb prepayment meters, we recommend that Ofgem change Standard Licence Condition 22B.7(b) to allow suppliers to set prices to prepayment customers on the basis of grouping regional cost variations and deprioritise potential enforcement action against suppliers in relation to this licence condition pending the change. This will allow suppliers to make better use of their limited tariff codes.

87. We are also proposing a remedy to enhance prepayment customers' ability and incentives to engage in the markets and to switch to other suppliers (including by switching to tariffs available on standard meters). This takes the form of a recommendation to Ofgem to take appropriate steps to ensure that changes to the Debt Assignment Protocol (currently being developed by Ofgem and the industry) are implemented by the end of 2016, and in particular in areas relating to objection letters, complex debt and issues relating to multiple registrations.

Helping customers engage to exploit the benefits of competition

88. Engaged customers are an essential component of well-functioning energy markets. If customers are not fully aware of the options available to them, unable to make an informed choice about the relative merits of those options or, having made a choice, are unable to switch, then competitive pressures on suppliers to reduce prices and improve quality of service will be substantially reduced.

89. In our provisional findings report we found that considerable numbers of customers were disengaged, leading to our provisional finding of a Domestic Weak Customer Response AEC. From our customer survey we found that 34% of respondents said they had never considered switching supplier,

while 56% of respondents said they had never switched supplier, did not know if it was possible or did not know if they had done so.

90. We also note that currently around 70% of customers are on the relatively expensive default tariff – the standard variable tariff – and that there are material, persistent gains from switching supplier, tariff and/or payment method that go unexploited by many customers.

91. We have proposed a wide range of remedies that attempt to improve domestic customer engagement by addressing aspects of the features contributing to the Domestic Weak Customer Response AEC. We propose five broad categories of remedy, which focus on the role of different participants in the retail markets – namely, Ofgem, the customer's own supplier, third party intermediaries (TPIs), and rival suppliers – in strengthening domestic customer engagement. In particular, the proposed remedies provide for:

(a) the establishment by Ofgem of a programme to provide customers – directly or through their own suppliers – with information to prompt them to engage;

(b) Ofgem making greater use of principles rather than prescriptive rules in addressing potential adverse supplier behaviour concerning the comparability of their tariffs;

(c) enhancing the ability and incentives of TPIs to promote customer engagement in the retail energy markets;

(d) creating an Ofgem-controlled database of 'disengaged customers' on default tariffs, to allow rival suppliers to prompt these customers to engage in the retail energy markets (the Database remedy); and

(e) requiring all suppliers to make all their single-rate tariffs available to domestic customers on any type of restricted meter, without making switching conditional on a restricted meter being replaced and to provide additional information to customers on restricted meters.

92. The different market participants identified above differ substantially in terms of the incentives they have to engage customers and their ability to do so and our range of proposed remedies reflects this.

Regulatory interventions to improve engagement/mitigate incentives to keep customers disengaged

93. We consider that customers' current suppliers have the ability to engage their customers – through the regular communications they send to them – but are likely to face limited incentives to do so in a way that encourages customers to engage in the markets. Indeed, since those customers that have not engaged in the markets recently are both less likely to switch and generally on higher tariffs than those who have recently engaged, their suppliers are likely to face a financial incentive to keep them as disengaged as possible.

94. In these circumstances, we recognise that there is an argument for Ofgem to intervene directly to facilitate customer engagement, through influencing the form, content and frequency of communication between suppliers and their existing customers. Ofgem has also recognised the importance of clear information in facilitating customer engagement and introduced the 'clearer information' component of the RMR rules in an attempt to ensure that suppliers' routine communications to customers were clear, easy to understand and personalised to them.

95. However, our concern with these provisions is that they were not subject to adequate testing prior to (or after) their introduction. Without adequate testing it is not possible to know which approach will work best in practice. Further, even if testing is conducted ex ante, changes in technology and cultural practices are likely to mean that what works changes over time.

Ofgem-led programme

96. Our proposed remedies therefore call for a more evidence-based approach to developing such interventions in the future, through the use of rigorous testing and trialling, where appropriate through Randomised Controlled Trials, with a recommendation to focus such trials on a shortlist of measures. If such trials are to provide relevant information that can provide a robust basis for regulatory changes, it is essential that suppliers be required to participate, where the trial design requires it, and our remedies therefore seek to ensure such participation.

97. In particular, the remedies comprise: a recommendation to Ofgem to establish an ongoing programme of identifying, testing and implementing measures to promote engagement in the domestic retail energy markets; and an invitation for all suppliers to offer undertakings to participate in the programme (failing which we would pursue alternative methods of ensuring

compliance such as the use of our order-making powers, changes to licence conditions or legislative change).

Principles rather than rules

98. Our remedies also place a greater emphasis on the use of principles rather than detailed rules in seeking to address potential adverse supplier behaviour, reflecting our concern that prescriptive rules can never be fully exhaustive and risk encouraging gaming behaviour on the part of suppliers. In particular, we recommend that Ofgem introduce an additional 'standard of conduct' into Standard Licence Condition 25C that would require suppliers to have regard in the design of tariffs to the ease with which customers can compare 'value for money' with other tariffs they offer.

Harnessing the incentives of rival suppliers and third party intermediaries to engage customers

99. Where market participants have an active incentive to engage customers – this category includes rival suppliers and TPIs – the proposed remedies serve to enhance these parties' ability to engage domestic customers. The proposed remedies seek to achieve this through:

(a) lifting certain regulatory restrictions that dull PCWs' incentives to compete to engage customers (amending provisions of the PCW confidence code that undermine incentives for them to be active in the retail energy markets);

(b) liberalising access to data by:

(i) giving PCWs access to the ECOES and SCOGES databases[10] and bolstering the Midata programme to allow TPIs to make more effective use of customer data; and

(ii) creating an Ofgem-controlled database of 'disengaged customers' who have been on the default tariff for three years or more, to allow rival suppliers to prompt these customers to engage in the retail energy markets.

[10] The Electricity Central Online Enquiry Service (ECOES) database includes certain data to assist electricity suppliers in the transfer of customers, while the Single Centralised On-Line Gas Enquiry Service (SCOGES) database comprises similar data for gas.

Enhancing the ability and incentives of third party intermediaries to promote customer engagement

100. We consider that TPIs such as PCWs are an important means by which customer engagement can improve and effective competition can develop in the domestic retail markets. PCWs have a strong commercial incentive to engage with domestic customers and provide access to their services both online and by telephone. PCWs are also well-placed to: raise awareness among customers of their ability to switch and the potential benefits from doing so; reduce search costs for customers; and exert competitive pressure on energy suppliers by enhancing price transparency and facilitating the purchasing process for customers.

101. Our aim in our proposed remedies relating to TPIs in the domestic retail markets is to help ensure that this potential for PCWs to promote competition to the benefit of customers can be realised by removing regulatory burdens that inhibit this role.

102. To strengthen PCWs' role in facilitating switching our remedies take the form of: orders to Gemserv and Xoserve to give PCWs access upon request to the ECOES and SCOGES databases respectively on reasonable terms and subject to satisfaction of reasonable access conditions.

103. To strengthen PCWs' incentives to engage customers, we are proposing to recommend to Ofgem that it remove the Whole of the Market Requirement in the Confidence Code and introduce a requirement for PCWs accredited under the Confidence Code to be transparent over the market coverage they provide to energy customers. Further, we are proposing to recommend to DECC several changes to the Midata programme that (subject to customer consent) would give PCWs increased access to more customer data and, in so doing, enable PCWs to monitor the market on behalf of their customers and advise them of savings.

104. We are aware of the concerns around trust that led to the Confidence Code requirement that PCWs list all tariffs on the market rather than just those for which they earn a commission. We believe that such concerns around trust can be addressed – without undermining TPIs' incentives to engage customers – in two ways.

105. First, there should be greater clarity around the role of PCWs – effectively acting as brokers offering customers good deals and facilitating switches rather than repositories of all available tariffs. Second, we considered recommending that Ofgem establish a non-transactional PCW listing all tariffs. We note, however, that Citizens Advice is now operating a non-

transactional PCW which lists all tariffs through a web-based service, which we believe will meet the needs of those customers who wish to see the whole of the market (and therefore do not propose to pursue a recommendation that Ofgem provide such a service).

Ofgem-controlled database of 'disengaged customers'

106. Around 70% of the customers of the Six Large Energy Firms are on the standard variable default tariff – ie a tariff that, for many, they did not actively choose. In our provisional findings report, we found that over 30% of the standard variable tariff customers of the Six Large Energy Firms had been on the standard variable tariff with the same supplier for more than five years.

107. In order to enable suppliers to prompt domestic customers of rival suppliers on default tariffs, our proposed remedy would require energy suppliers to disclose certain details of their domestic customers (on any meter type) who have been on their standard variable tariff (or any other default tariff) for three or more years (the 'Disengaged Domestic Customers') to Ofgem, and would recommend that Ofgem retain, use, and disclose this data (via a centrally managed database) to rival suppliers. The Disengaged Domestic Customers would have the option to opt out of the disclosure process at any point in time.[11]

108. The aim of the proposed remedy would be to enable rival retail energy suppliers to identify the Disengaged Domestic Customers that have not opted out and prompt such customers to engage in the markets. The ultimate aim of this proposed remedy would be to partly address two of the features identified in the provisional findings report giving rise to the Domestic Weak Customer Response AEC (and resulting detriment), ie that domestic customers have limited awareness of, and interest in, their ability to switch energy supplier and that domestic customers face actual and perceived barriers to accessing and assessing information.

109. We recognise that there is a trade-off between the benefits of liberalising channels of engagement and the need to protect customers from excessive and/or misleading marketing. In respect of each of our proposed remedies to liberalise access to customer data, such data will only be available if customers actively choose to make it available (except in relation to communication with customers on the default tariff database, where

[11] In the design of this remedy, we have drawn on discussions with the Information Commissioner's Office concerning the implications of the Data Protection Act 1998 and the Privacy and Electronic Communications Regulations 2003.

customers will still have the right to opt out beforehand, and will only be contacted by post unless the customer agrees otherwise).

110. Any communications from suppliers will be subject to standards regarding the form they must take to ensure they are sufficiently clear and informative and a failure to comply with these standards may result in access to the database being withdrawn by Ofgem.

Remedies for customers on restricted meters

111. We believe that the above proposed remedies will help customers on any meter type engage effectively in retail energy markets. Further, to address the specific problems faced by customers on restricted meters in shopping around for better deals and in switching, we propose a set of additional remedies that: require all suppliers to make all their single-rate tariffs available to any domestic customer on any type of restricted meter, without making switching conditional on a restricted meter being replaced; and ensure that domestic customers on restricted meters have access to information on the options available to them.

The impact of smart meters on competition and engagement

112. The roll-out of smart meters to domestic customers is due to be completed by the end of 2020.

113. The introduction of fully-functional (SMETS 2) smart meters will address the technical constraints arising from the dumb prepayment infrastructure. Notably, the problems arising from tariff slots, and their allocation between suppliers, will cease to exist. We also consider that smart meters should address the specific barriers to engagement experienced by customers on restricted meters, although we note that smart meter equivalents are not currently available for all restricted meter types.

114. In relation to customer engagement more generally, we consider it likely that smart meters will help improve customer engagement by making the relationship between prices and consumption more visible and improving the accuracy of bills, although the extent of this effect is uncertain.

115. In view of the benefits of smart meters for competition and engagement, and more specifically for helping to address some of the features we have identified, we believe is it vitally important that the prescribed timetable for their roll-out is adhered to. Ofgem has the power to impose penalties on suppliers in the event that the prescribed timetables are not met and we would expect it to use these tools effectively to ensure that suppliers comply

with their obligation to take all reasonable steps to complete the roll-out by 2020.

Expected costs and benefits from our remedies package

116. We have considered the likely costs and benefits of our proposed remedies package, distinguishing between those measures that will have an effect solely during the transitional period of the smart meter roll-out and those that will have an enduring effect, particularly from around 2019/20 onwards.

Remedies that will have an effect solely during the transitional period

117. Some of our proposed remedies will apply only during the period before the completion of the roll-out of smart meters (end 2020) or earlier. These are: the remedies relating to the allocation of gas tariff pages; the remedies giving TPIs access to the SCOGES and ECOES database; and the remedies designed to improve engagement for customers on restricted meters.

118. We consider that the costs of implementation of the above remedies are very low. In relation to the first two, there would a minimal administrative cost for Ofgem, Gemserv and Xoserve respectively. In relation to the third, there would be a small additional cost for suppliers arising from the need to aggregate consumption volumes in different registers for the purposes of single rate billing.

119. Given the short space of time over which these remedies will be relevant and the inevitable lag between the implementing of the remedy, effectively addressing the feature and reducing detriment, we do not expect that these remedies alone will have very substantial effects in terms of reducing customer detriment. However, given the scale of the total customer detriment that we have identified for prepayment customers almost £500 million in 2015, and customers on restricted meters around £40 million in Q2 2015 even very small reductions in prices during the transitional period would lead to benefits that would far exceed any implementation costs.

Remedies that will have an enduring effect

120. The other remedies that we have proposed – settlement reform, the withdrawal of aspects of the simpler choices component of the RMR rules and the engagement remedies other than the transitional measures discussed above – would work together on an enduring basis as a package. We have accordingly considered their benefits jointly, while noting their

relative contribution to the package and identifying their costs, where material, on an individual basis.

121. We first assess costs and benefits for electricity settlement reform separately, as this reform has benefits in terms of load shifting that are additional to those of the package as whole (although we consider that they would also make a contribution to improving customer engagement).

Electricity settlement reform

122. There are potentially substantial savings from domestic peak load shifting, arising primarily from reductions in the cost of generation and distribution. One recent study estimated savings from the introduction of time-of-use tariffs within the domestic retail markets of between roughly £50 million and £100 million in 2020 and between roughly £100 million and £350 million a year by 2025.[12] Expected savings increase with the roll-out of automated and dynamic time-of-use tariffs (for which settlement reform is necessary) and with increased penetration of low carbon technologies. We note in relation to this latter factor that the demand and supply of heat pumps, smart appliances and electric vehicles will be driven in large part by the availability of opportunities to exploit within-day price differentials. Therefore we would argue that a move to half-hourly settlement will be a necessary step in achieving the higher end of potential benefits from demand-side response.

123. In terms of implementation costs, we consider that these will be very low or nil for distribution network operators and that half-hourly settlement will overall result in a reduction in costs for Elexon. Suppliers indicated to us that the reform would involve substantial upfront and ongoing costs, although we did not receive sufficient information from enough firms to build a consistent, robust picture of the likely costs.

124. Our recommendation is that Ofgem conduct a full cost-benefit analysis of the move to mandatory half-hourly settlement, but overall, and based on the evidence we have seen, there are good reasons to expect the benefits from half-hourly settlement to outweigh the costs of its implementation by a substantial degree.

Effect of the package on engagement

125. In relation to the rest of the package, we consider that the main enduring benefit will accrue from improving customer engagement and therefore

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[12] Baringa and Element Energy (August 2012), *Electricity System Analysis – future system benefits from selected DSR scenario*.

overcoming the Domestic Weak Customer Response AEC. We note that, almost 15 years after full price liberalisation, around 70% of the customers of the Six Large Energy firms are on the default tariff, despite very large and growing potential gains from switching. Nevertheless, we believe that our reforms will succeed in improving engagement where other interventions have failed.

126. First, past interventions have been based largely on *a priori* reasoning, with little attempt systematically to test hypotheses through rigorous trials or other forms of testing before the intervention is implemented. *A priori* reasoning can provide useful insights into the sorts of interventions that may help, but rigorous evidence is needed to ensure that those interventions that are most likely to make a difference for given customers at a given point in time are implemented. The Ofgem-led programme that we proposed to recommend is therefore essential to ensure that future interventions are based on what works in practice.

127. Second, our proposed remedies seek to harness the incentives of TPIs and rival suppliers to unlock customer engagement, by giving them greater access to the data they need to perform this role more effectively and at lower cost. TPIs have grown considerably as an acquisition channel over the past few years and we believe that through our remedies they can continue to grow in importance, lowering acquisition costs for suppliers and lowering search costs for customers.

128. In relation to the Database remedy, we recognise that any proposal to free up access to customer data may be controversial, but we believe that such measures are necessary if customers who have not engaged for years are to consider switching in the future. We propose to put in place safeguards to ensure that such data is used appropriately.

Costs and benefits of engagement remedies

129. In relation to the costs of implementing the remedies, these are generally very low compared with the size of the detriment. For example, in relation to the Database remedy, we have estimated that the costs of setting up a secure cloud database in which to store details of the Disengaged Domestic Customers could be in the region of £50,000–100,000.

130. The largest cost would be imposed by the Ofgem-led programme, as it would require an ongoing system of testing and trialling interventions. The Behavioural Insights Team told us that the costs of the trials that it had conducted to date had been between £20,000 and £90,000 per trial, although we note that costs may vary substantially, depending on the size

and complexity of the trial. In designing the programme and, in particular, the extent of any supplier participation that might be needed, we note that Ofgem will be required to assess the proportionality of the various stages involved in the programme.

131. We believe that the benefits of our remedies will be seen in part through a reduction in the average gains from switching that go unexploited by customers. However, crucially, this would not be achieved by a levelling up of prices (a potential risk of regulatory interventions that seek to constrain price differences) but by a gradual reduction in prices towards the competitive benchmark level, as more efficient suppliers gain customers from the less efficient.

132. Given the size of the detriment we have identified (about £1.7 billion a year since 2012, with an upwards trend), it would only take a very small (less than 1%) reduction in this detriment to offset the costs of even a highly comprehensive, onerous set of trials conducted through the Ofgem-led programme. We believe that our package of remedies will be much more effective than this in reducing customer detriment on a sustained basis, and that it therefore represents an effective and proportionate response to the problems we have identified.

Transitional price cap for prepayment customers

133. We believe that competitive retail energy markets, in which energy suppliers operate free of inefficient technical and regulatory restrictions, and customers make informed decisions about the range of choices available to them, represent the best long-term approach to delivering positive outcomes for energy customers.

134. We have identified substantial problems on both the supply- and the demand-side of the retail energy markets, and we believe that our remedies package will provide a long-term solution to them, by putting downwards pressure on prices towards the competitive benchmark level.

135. However, our proposed remedies will take time to implement before they start to address the features that we have identified and, in turn, reduce the detriment to domestic customers arising from them. As a result, we expect that the detriment arising from the Domestic AECs we have provisionally identified will persist in substantial form for the next few years. Given the size of the detriment we have observed, of around £1.7 billion a year over the last three and a half years, with a marked increase in detriment year on year, we have therefore considered the need to intervene to address

domestic customer detriment directly in this transitional period, through a price cap.

136. We have provisionally concluded that a price cap should apply to domestic customers on prepayment meters for a transitional period (2017 to the end of 2020). In reaching this provisional decision, we have given consideration to a number of factors, including: the strength of the features contributing to the Prepayment AEC and the Domestic Weak Customer Response AEC as it applies to prepayment customers; and the level of detriment suffered by prepayment customers.

137. The level of detriment suffered by prepayment customers is particularly high. Over the period 2012 to Q2 2015, detriment expressed as a proportion of the bill for prepayment customers was substantially higher than that for direct debit and standard credit customers for both dual fuel customers and single fuel electricity customers, as set out above. Further, we note that, unlike other customers, where prepayment customers pay too high a price, part of the detriment is likely to be felt in abruptly curtailed consumption.

138. We also consider that a cap covering a relatively restricted proportion of customers, such as prepayment customers (about 16% of the total customer base), is likely to be less prone to adverse consequences than a cap covering a broader group and that the use of an easily identifiable criterion for qualification (such as being on a prepayment meter) will help ensure that the remedy is easily implementable within a short period of time.

139. We have provisionally decided to implement a 'reference price and cost index approach' to set the cap for prepayment customers, which would involve setting an initial level of the prepayment cap based on our competitive benchmark analysis (as discussed above) and then allowing the cap to change over time according to movements in exogenous cost indices, including wholesale costs, network costs, policy costs and inflation.

140. In considering the design and stringency of the cap, we have been particularly mindful of the need to avoid distortions to competition, while reducing customer detriment. Notably the design – unlike alternatives we considered – does not lead to a risk of perverse incentives on the part of suppliers. Further, the fact that the cap is strictly time-limited and will be implemented according to an objective formula, will help minimise the risk of regulatory gaming behaviour.

141. In determining the overall level of the cap, we have provisionally decided to include headroom of £25 per fuel per year (ie £50 headroom in a dual fuel cap). This will mitigate the risk that the cap does not allow for the recovery of

efficient costs and help ensure that competition in the prepayment segments can coexist with the cap. Indeed, the proposed level of the cap as of Q2 2015 is generally in line with the cheapest prepayment tariff prices in many regions and we believe that it will be possible for competitive tariffs to undercut the level of the cap.

142. At the current proposed level, we anticipate that the cap will materially reduce detriment for prepayment customers. Had it applied in Q2 2015, it would have reduced prepayment customer detriment – and, equivalently, the revenues of the Six Large Energy Firms – by about £300 million per year, equivalent to a reduction in the average bills paid by prepayment customers of over 8%.

143. We note that the proposed price cap would also apply to Mid-tier Suppliers and smaller suppliers and will therefore result in revenue reductions outside of the Six Large Energy Firms. The extent of revenue reductions for each supplier will be determined by the level of detriment currently experienced (in the form of high prices) by their prepayment customers.

144. We anticipate that, as our remedies to address supply-side constraints and improve customer engagement begin to take hold towards the end of the cap, and as smart meter roll-out increases, competition rather than the cap will be determining the prices paid by most customers. There will therefore be a graduated glide path to the termination of the cap at the end of 2020.

145. While the detriment suffered by prepayment customers is particularly high, we note that other domestic customers will also suffer detriment during the transitional period before full implementation of our remedies, and have therefore given consideration to the application of a price cap to broader categories of customers, notably all customers on the standard variable tariff.

146. Our provisional view is that the costs of attempting to address the detriment of all customers on the standard variable tariff through a price cap would likely be disproportionate. We believe that attempting to control outcomes for the substantial majority of customers would – even during a transitional period – run excessive risks of undermining the competitive process, likely resulting in worse outcomes for customers in the long run. This risk might occur through a combination of reducing the incentives of suppliers to compete, reducing the incentives of customers to engage and an increase in the perception of regulatory risk.

147. Since, as noted above, a large part of the detriment we have observed in the form of high prices is likely due to inefficiency rather than excess profits, we

believe the best, most sustainable approach to reducing this detriment in the long term is through fully competitive markets, in which more efficient suppliers gradually replace less efficient suppliers. Having considered very closely both the short-term benefits to customers and the longer-term risks that a broader cap may create, set against the features of the Domestic Weak Customer Response AEC, we have therefore provisionally decided, on balance, not to propose an intervention to control prices across all customers on standard variable tariffs

Microbusiness retail remedies

148. In the provisional findings report, we found that a combination of features of the markets for the retail supply of gas and electricity to small and medium-sized enterprises (SMEs) in Great Britain gave rise to an AEC through an overarching feature of weak customer response from microbusiness customers. We said that this gave suppliers a position of unilateral market power over their inactive microbusiness customers, which the suppliers were able to exploit through their pricing policies or otherwise (the Microbusiness Weak Customer Response AEC).

Detriment suffered by microbusinesses

149. We have updated our analysis of the detriment arising from the Microbusiness Weak Customer Response AEC. Our revised estimate is that the profits in excess of the cost of capital earned by the Six Large Energy Firms from the supply of gas and electricity to SME customers amounted to approximately £280 million per year from 2007 to 2014,[13] of which we estimate that approximately £230 million per year related to microbusiness customers.

150. We consider that this is a conservative estimate of detriment, as we have confined our estimate of detriment to a consideration of profits in excess of the cost of capital – that is, we have not included any estimate of inefficiency. We also note that we have not been able to conduct an analysis of supplier bills to produce an alternative, and more direct, estimate of detriment, as we have done for domestic customers.

151. Despite this conservative approach, we believe that the size of the detriment that we have identified is significant. The annual profits in excess of the cost of capital amounted to 6% of average annual microbusiness revenues for the Six Large Energy Firms from FY 2007 to FY 2014. This suggests that

[13] The years referred to are financial years.

prices may have been on average 6% higher between FY 2007 to FY 2014 than would have been the case in a better-functioning market.

Remedies for microbusinesses

152. We have assessed remedies for microbusiness customers considering the same strategic themes as for domestic customers: creating a framework for effective competition; helping customers engage; and protecting customers who are less able to engage to exploit the benefits of competition.

Creating a framework for effective competition

153. Our proposed remedies concerning the electricity and gas settlement systems, as discussed above, would also apply to microbusiness customers. In particular, the plan to move customers in profile classes 1 to 4 to mandatory half-hourly settlement in electricity would affect the majority of microbusiness customers (around 90% of which currently fall into profile classes 3 and 4). Similarly, the proposed remedy to increase the accuracy of the gas settlement system will benefit microbusiness as well as domestic customers.

154. The other remedies that we are proposing with a view to improving the framework for competition for domestic customers either affect very few microbusiness customers or do not apply at all in the microbusiness segments.

Helping microbusiness customers engage to exploit the benefits of competition

155. The main remedies we are proposing regarding microbusiness customers are those designed to help them engage to exploit the benefits of competition. These include remedies to:

(a) increase price transparency;

(b) end auto-rollover contracts[14] with certain restrictions (such as termination fees) that restrict microbusiness customers' ability to switch;

(c) establish a programme to provide microbusiness customers with information to prompt them to engage; and

[14] Auto-rollover contracts are fixed-term, fixed-price contracts that microbusiness customers can be moved onto if they fail to negotiate new terms when their existing contract comes to an end.

(d) provide prompts to microbusiness customers on default contracts by enabling rival suppliers to contact them.

156. We believe that our engagement remedies will play a key role in addressing the features giving rise to the Microbusiness Weak Customer Response AEC, and the resulting customer detriment.

Price transparency remedy

157. The price transparency remedy would require suppliers to disclose the prices of all their available acquisition and retention contracts to a large proportion of their microbusiness customers. As an additional measure, it would also require suppliers to disclose their out-of-contract (OOC) and deemed contract prices on their websites. The measure in relation to acquisition and retention contracts would significantly increase microbusiness customers' abilities to access and assess price information. It would also facilitate the development of PCWs catering for microbusiness customers, which would further reduce the high search costs faced by microbusiness customers. As a result, the price transparency remedy would address barriers to accessing and assessing information experienced by microbusinesses.

Auto-rollover remedy

158. The auto-rollover remedy would address certain barriers to switching that microbusiness customers on auto-rollover contracts face by: *(a)* increasing the time window during which microbusiness customers would be able to give their termination notice to suppliers; and *(b)* prohibiting suppliers from including certain restrictions (prohibiting both termination fees and the use of no-exit clauses).

159. Our proposed remedies will also prohibit termination fees in relation to evergreen and OOC contracts. This measure, together with the measure to prohibit termination fees in relation to auto-rollover contracts, would effectively ensure that suppliers would not be permitted to charge termination fees on default contracts with their microbusiness customers, thereby reducing the barriers to switching for microbusiness customers on evergreen and OOC contracts.

Programme to provide microbusiness customers with information to prompt them to engage/Database remedy

160. The remedies to establish a programme to identify additional (or new) information from suppliers to prompt microbusiness customers to engage,

and to disclose the details of their most disengaged microbusiness customers to rival suppliers would increase the engagement of microbusiness customers on default contracts. By incentivising microbusiness customers to engage, we would expect the competitive constraint on energy suppliers to increase. This would incentivise suppliers to reduce the prices of their available acquisition and retention contracts for microbusiness customers.

Protecting customers who are less able to engage to exploit the benefits of competition

161. We have also considered the case for introducing a price cap for microbusiness customers on prepayment meters. We have provisionally decided not to do so, on the grounds that the costs associated with implementing a price cap for the microbusiness segments would be large relative to the potential benefits, which would accrue to a very small number of microbusiness customers (less than 1% of whom are on prepayment meters).

Costs and benefits of the remedies package

162. In developing our proposed remedies, we have been mindful to ensure that they work together as a coherent package, which, as a whole, provides an effective and proportionate means of addressing the Microbusiness Weak Customer Response AEC, and the resulting customer detriment.

163. We have considered whether the benefits of the remedies package as a whole would be likely to exceed the overall costs of the package.

164. In relation to costs, we estimate that the price transparency remedy would be likely to impose a one-off cost on the Six Large Energy Firms of approximately £750,000; and on all suppliers these costs could amount to approximately £4.5 million if they all adopted the more expensive online quotation tool option. We do not expect the auto-rollover remedy to impose substantial costs on suppliers, and we estimate that the costs of extending the remedy that would enable prompts to microbusiness customers on default contracts to the microbusiness segments would be minimal for suppliers.

165. The costs of the Ofgem-led programme may be more substantial but we note that, in designing the programme and, in particular, the extent of any supplier participation that might be needed, Ofgem will be required to assess the proportionality of the various stages involved in the programme.

166. In relation to benefits, we consider that there is substantial scope for price reductions and that the remedies would still be proportionate if they led to only a small reduction in prices for microbusiness customers. On the basis of our profitability analysis, we consider that prices for the microbusiness customers of the Six Large Energy Firms could have been on average 6% lower between FY 2007 and FY 2014 in a better-functioning market, equivalent to £230 million a year – and we expect a material reduction in prices from the introduction of our remedies.

167. We have therefore concluded that the benefits of the remedies package for all microbusiness customers are likely to substantially exceed the costs that it would impose on all suppliers in the microbusiness segments.

Remedies relating to the governance of the regulatory framework

168. Efficient and robust rules and regulations are fundamental to well-functioning energy markets. In the provisional findings report, we provisionally identified a number of features of the regulatory framework governing energy markets that led to AECs. We found in particular that these features were likely to increase the risk of policies being developed in the future that are not in customers' interests and inhibit the development of policies that are in their interests.

169. In relation to the governance of the broader regulatory framework, we have provisionally found that:

(a) Ofgem's statutory objectives and duties may constrain its ability to promote effective competition;

(b) there is a lack of a formal mechanism through which disagreements between DECC and Ofgem over policy decision-making and implementation can be addressed transparently;

(c) the impact of government and regulatory policies over energy prices and bills has not been effectively communicated; and

(d) there is a lack of a regulatory requirement for clear and relevant financial reporting concerning generation and retail profitability.

170. As regards the governance of industry codes, where many of the detailed rules underpinning market operation are specified, we have provisionally found that parties have conflicting interests and/or limited incentives to promote and deliver policy changes and that Ofgem has insufficient ability to influence the code modification process.

Detriment arising from problems in the regulatory framework

171. The problems we have identified relate to the processes, structures and institutions involved in regulatory decision-making in the energy sector. They are systemic in nature, having an impact across all of the energy markets that we have identified. While the detriment arising from these provisional AECs is, by its nature, difficult to quantify, we consider that it is likely to be very substantial.

172. First, the costs of energy policies – the transfers and subsidies put in place to achieve government policy objectives such as reducing greenhouse gas emissions – will comprise an increasing proportion of customers' energy bills. On the basis of current announced plans, DECC estimates that climate and energy policies will add 37% to the retail price of electricity paid by households in 2020.[15] Further, some policies – such as the roll-out of smart meters – are expected to improve energy efficiency and hence reduce energy bills. Given the central role that government policies are expected to play in determining energy bills in the future, we believe it is vital that policy decisions are robust, and informed by a transparent analysis of their impacts on customers.

173. Second, energy markets are highly regulated, and the nature of competition in these markets is shaped by the design of the regulatory regime to a much greater extent than in most other markets. This is particularly the case for wholesale markets, which currently comprise around 50% of the costs faced by electricity and gas customers, and where the nature and size of technological and regulatory changes expected over the next few years are substantial. We also note that many of the competition problems that we have identified in the retail energy markets – the settlement systems for gas and electricity, which fail to give suppliers the right incentives, the introduction of the RMR simpler choices reforms, which have stifled innovation – are regulatory in nature, reflecting specific provisions in legislation, licence conditions and industry codes.

Package of remedies

174. We have developed a package of proposed remedies designed to improve the governance of the regulatory framework. The proposed remedies relate to five specific areas: Ofgem's duties and objectives; the relationship between DECC and Ofgem; the analysis of the impacts of policy and

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[15] 2014 prices. Source: DECC (November 2014), Estimated impact of energy and climate change policies on energy prices and bills.

regulation; the regime for financial reporting; and governance of the industry codes.

175. While the proposed package is broad, affecting the full range of regulatory instruments and processes (legislation, licence conditions and industry codes), it is based on a simple set of principles, which recognise the importance of: well-defined powers and objectives aligned with the interests of customers; clear responsibilities and transparent, coordinated implementation; robust analysis underpinning decision-making and improving transparency; and an independent and authoritative regulator.

Ofgem's duties and objectives

176. Our provisional view is that Ofgem's statutory objectives and duties may, in certain circumstances, constrain its ability to promote effective competition. In particular, Ofgem told us that it considered that its duty to pursue its principal objective by 'wherever appropriate promoting effective competition' had been progressively downrated relative to other duties over the last ten years.

177. Our proposed remedy is a recommendation to DECC to amend primary legislation in order to clarify Ofgem's statutory objectives and duties and thereby remove any constraint (actual or perceived) on Ofgem's ability to pursue its principal objective (protecting the interests of existing and future customers) by promoting effective competition where it considers this appropriate.

Relationship between DECC and Ofgem

178. DECC and Ofgem have complementary and, in some cases, overlapping responsibilities in relation to regulatory and policy development in the energy sector. In some cases, the implementation of a particular energy policy requires a combination of measures taken by DECC (mainly through legislation), Ofgem (mainly through licence conditions) and indeed the industry (through the amendment of codes).

179. We have two concerns regarding the relationship between DECC and Ofgem. First, we noted in our provisional findings report that two of Ofgem's most important decisions in recent years (neither of which we consider to have benefited customers)[16] were taken against a backdrop of DECC taking powers – or stating its readiness to take powers – to implement changes in

[16] The introduction of the simpler choices component of the RMR reforms in 2013 and of Standard Licence Condition 25A in 2009, prohibiting regional price discrimination.

primary legislation in the event that Ofgem did not act, and that the coincidence of DECC's and Ofgem's actions risked creating the perception of a lack of independence on the part of Ofgem. Second, we identified inefficiencies in the implementation of certain policy objectives (for example, the introduction of 17-day switching and half-hourly settlement for certain categories of customer) due to a lack of effective coordination.

180. We propose two remedies that are designed to recalibrate the relationship between DECC and Ofgem in a way that recognises Ofgem's independence while allowing for appropriate coordination of activities to deliver overarching policy goals:

(a) First, we propose to recommend legislation to establish a clear process requiring Ofgem to publish opinions on all draft legislation and policy proposals that are relevant to its statutory objectives and that are likely to have a material impact on the GB energy markets.

(b) Second, we propose to recommend to DECC and Ofgem that they publish detailed joint statements setting out action plans for the implementation of proposed DECC policy objectives that are likely to necessitate Ofgem interventions, with clear responsibilities and timetables.

Transparent analysis of the impacts of policy and regulation

181. As noted above, government policies are having an increasing impact of energy bills and yet we have provisionally found that there is a lack of effective communication concerning the forecast and actual impact of government and regulatory policies on energy prices and bills. This has led to a lack of trust between stakeholders and is one of the features contributing to an overarching feature of a lack of robustness and transparency in regulatory decision-making.

182. To help address this, we propose to recommend to Ofgem that it publish annually a state of the market report which would provide analysis regarding issues such as the evolution of energy prices and bills over time; the profitability of key players in the markets; the social costs of policies and distributional impacts arising from them; and the impact of initiatives relating to decarbonisation and security of supply. We also propose to recommend the creation of a team within Ofgem to take this work forward.

Regime for financial reporting

183. We have provisionally found that current regulatory requirements do not provide for clear and relevant financial reporting of generation and retail profitability. Our proposed remedy seeks to address this, and in so doing to help ensure that Ofgem will be better placed in the future to make decisions using relevant financial information and to provide a clear and trusted assessment of the GB energy markets. This in turn should inform the public debate and support the development of appropriate policies.

184. Our proposed remedy will require the Six Large Energy Firms to:

(a) report their generation and retail supply activities on market rather than divisional lines;

(b) report a balance sheet as well as a profit and loss account separately for their generation and retail supply activities;

(c) disaggregate their wholesale energy costs for retail supply between a standardised purchase opportunity cost and a residual element; and

(d) report prior year figures prepared on the same basis.

185. We propose to implement this remedy by means of a recommendation to Ofgem to introduce relevant changes in the licence conditions of the Six Large Energy Firms.

Governance of industry codes

186. Industry codes are multilateral agreements that define the terms under which industry participants can access the electricity and gas networks, and the rules for operating in the relevant markets. Industry participants have a key role in the governance of these codes, and, under the current regime, proposed reforms that can have substantial impacts on competition and the delivery of policy objectives are implemented through code changes (the proposals to introduce half-hourly settlement and cash-out reforms are recent examples).

187. In our provisional findings report, we provisionally found that the current system of industry code governance limits innovation and pro-competitive change and causes the energy markets to fail to keep pace with relevant policy objectives. We found that this was due in particular to:

(a) parties' conflicting interests and/or limited incentives to promote and deliver policy changes; and

(b) Ofgem's insufficient ability to influence the development and implementation phases of a code modification process.

188. Current governance structures give industry participants a key role in decision-making even though their incentives are often not aligned with those of customers. Further, we note that incentives often differ between firms, leading to lengthy and costly regulatory processes and delays in decision-making. Examples of this include the long-running deliberations over whether to introduce locational charges for transmission losses over the past 25 years and discussions regarding gas settlement reform.

189. We are also surprised to note that some decisions that appear to us to be fundamental to ensuring effective competition and meeting the needs of customers appear to be loosely governed under the industry codes, and not to have involved any formal role for Ofgem. For example, in relation to competition for customers on prepayment meters we understand, based on the relevant provisions set out in the Supply Point Administration Agreement, that there are no formal mechanisms in place to monitor the allocation of gas tariff pages and to govern the distribution of tariff pages between suppliers. This is of particular concern since the lack of access to gas tariff pages has been one of the factors inhibiting new entry into the prepayment segments, to the detriment of prepayment customers.

190. Our proposed remedy will see Ofgem taking a more proactive role in code development, by setting a Strategic Direction and engaging actively in the code modification process through its influence over licensed code bodies. Further, we recommend that Ofgem take powers to initiate code modifications where these are necessary to deliver the Strategic Direction and be given powers to take substantive control of any ongoing strategically important modification proposals, as appropriate.

191. We propose to recommend to DECC that it seek to pass legislation: giving Ofgem the ability directly to modify industry codes in certain exceptional circumstances; and making the provision of code administration and delivery services activities that are licensed by Ofgem. This will give Ofgem a means of requiring code bodies to take on an expanded role to deliver code modifications consistent with the Strategic Direction.

Overview of the proposed new regulatory framework

192. Our proposed remedies are individually incremental but in combination represent a substantial reform package. They represent a 'reset' of the regulatory framework governing the energy sector, clarifying and recalibrating the roles and responsibilities of Ofgem, DECC and industry to

help ensure that regulatory and policy decisions in the future are robust, efficient and timely, and driven by a concern for the interests of current and future customers.

193. Ofgem will be at the heart of this new regulatory framework, with a simpler and clearer focus on the interests of customers, an additional role to scrutinise and comment on government policies, greater access to relevant financial information from industry and greater powers to drive through changes to industry codes when these are needed to meet broader policy objectives and are in the interests of customers and competition.

194. We believe that the individual elements of our remedies package are mutually reinforcing. For example, the roles given to Ofgem to comment on and scrutinise the impacts of government policies on the one hand, and undertake greater scrutiny of companies' financial returns on the other, will help both to:

(a) improve the robustness of the decision-making process, the quality of regulatory decisions and transparency in public debates about energy; and

(b) bolster the perception of Ofgem as an authoritative, trusted and independent regulator, consistent with the greater responsibilities it will have in relation to code governance and reform.

195. We consider that our proposed reforms are fully consistent with the government's *Principles for Economic Regulation*[17] and its *Better Regulation Framework Manual.*[18] In particular, our proposed remedies should ensure that new policy proposals and existing policies and regulations are subject to robust scrutiny in terms of their costs and benefits. Further, our proposed remedies relating to the code governance process and mechanisms to improve coordination between DECC and Ofgem should serve to streamline and rationalise the policymaking process, reducing overall regulatory burdens.

Dissenting view

196. One panel member, Martin Cave, felt that the provisional retail remedy package was unlikely to succeed in reducing, in a timely way, the significant level of detriment identified. In his current view, a short-term price cap,

[17] BIS (April 2011), *Principles for Economic Regulation*.
[18] BIS (March 2015), *Better Regulation Framework Manual: Practical Guidance for UK Government Officials*.

covering a substantially larger number of customers, is required to reset the market.

Provisional decision on remedies

197. A comprehensive list of remedies is provided in Section 11 of this report.