FROZEN OUT

Business energy supply and the price freeze

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Since Labour first announced its intention to freeze energy prices should it form a government after the 2015 general election, questions have lingered about the practicalities of such a policy. Criticism has become more vocal in recent months, as wholesale energy prices have begun to slide, with William Hague MP, Leader of the House of Commons, blaming the policy proposal for suppliers' reluctance to reduce consumer costs more quickly.[1] Although Labour attempted to frame the freeze as a short-term fix within a broader set of policies, providing consumers with protection while the market is fully evaluated and a new regulator appointed, the freeze alone has captured press and public attention.

But political discussion of "the energy market" is misleading. In reality, Britain has several intersecting markets for energy. First, there's the wholesale market, where suppliers purchase electricity to sell to their customers. Then there are the markets where big businesses, commercial and industrial customers, buy their energy, using their size as a way of negotiating the best prices. And finally, there's the consumer market, where the "Big Six"[2] and a handful of other suppliers offer tariffs for household consumption. Nobody would argue that Britain's energy markets are free of problems. However the relative successes are also under-recognised.

This briefing paper explores the following issues, with the aim of informing Britain's policymakers about the true state of the nation's energy markets:

- How different segments of Britain's energy markets behave
- Where markets are failing to provide value
- Whether a price freeze is an appropriate policy response
- Which other policies could help boost competition and market efficiency in the energy sector

CONSUMER MARKETS

Problems in consumer energy markets are well-known and frequently discussed by politicians and the press. As well as motivating Labour's price freeze promise, they spurred Ofgem to refer the industry to the Competition and Markets Authority (CMA) for investigation in June 2014. Consumer tariffs are relatively complex, with prices varying depending on how the customer pays and when they last negotiated their tariff. The market is dominated by the Big Six, who provide around 93% of UK households with their energy.[3]

There have been concerns almost since the moment of privatisation that these firms overcharge and make excess profits. Many claim that their prices do not accurately reflect wholesale energy costs – quickly rising when prices for input fuels spike, but falling only slowly when the wholesale market turns. There is substantial evidence that the domestic energy supply market is not competitive. Average dual fuel prices increased by 24% between 2009 and 2013, 10 percentage

points ahead of general consumer price inflation which was 14% over the same period.[4] Analysis carried out by the CMA suggests that more than 95% of the Big Six's dual fuel customers could have saved significant sums of money by switching tariff or supplier.[5] Meanwhile profits on domestic energy supply for the Big Six have clearly increased in recent years, with the margin increasing from 0.9% to 4.3% between 2009 and 2013.[6] The domestic energy market clearly lacks competitive pressure and provides poor value to some consumers.

INDUSTRIAL AND COMMERCIAL SUPPLY

The industrial and commercial energy market, where businesses buy their power, is in many ways different to the domestic market. Here, competition is much stronger, and growing. At least 30 companies supply energy to businesses, compared to the 24 competing in domestic markets.[7] Smaller competitors to Big Six firms account for more than a fifth of the industrial and commercial market[8] - more than twice the market share they enjoy in the household supply market. Competition is strong enough that when the industry's regulator, Ofgem, asked the CMA to investigate the sector in June 2014, it argued that the industrial and commercial market could be excluded due a lack of evidence of harmful practices. In sharp contrast to the domestic market, the Big Six's profits in non-domestic markets fell slightly between 2009 and 2012 as the sector attracted new entrants. Even small and micro-businesses face a competitive market for their custom.[9]

WHERE ARE THE MARKET FAILURES?

By breaking down the energy market into these segments, we begin to get a better idea of where the market failures really lie. Why is it that the business energy supply market is so much more competitive than the domestic supply market? The answer lies in the demand side.

Businesses, particularly large businesses, have three advantages when purchasing energy.

- Firstly, they are highly motivated – the cost of power affects their competitiveness, and ultimately their margins. This is a powerful incentive to hunt for the right deal. While consumers do care about prices too, the motivation to cut household costs is not quite as clear.
- Secondly, larger businesses have access to better information about their requirements than consumers. While consumers (at least, until the smart meter roll out is completed), have to rely on estimates of their energy needs provided by suppliers, large businesses have the capacity to understand their own energy requirements, and resources to explore the market. They also tend to contract for no longer than 18 months, providing frequent opportunities to re-engage with the market and find a better deal. Businesses have access to brokers, who help them navigate the market and find the best deal,[10] a service currently unavailable to domestic customers. Each of these factors means businesses are more informed consumers of energy than households, which gives them an advantage in negotiating supply contracts.
- Finally, businesses have market power. Large businesses buy significant volumes of energy. This means each customer is more important to the supplier's business than is the case in the domestic market, and reduces the price-setting power of the provider. The scale of industrial and commercial customers changes the nature of the supply response. A new entrant to the business energy supply market need only secure a couple of large clients to set up their business. By contrast, a new domestic energy supplier will need to attract thousands of domestic customers in order to compete.

The difficulties facing new entrants to the household supply market have helped to prolong the dominance of the Big Six. Lack of competitive pressure on the incumbent players has, in turn, provided them with the ability to differentiate prices and offer some consumers better value than others by consistently charging more for certain tariffs.[11] Some consumers are active energy consumers, making use of price comparison websites and collective switching schemes to maximise the value they obtain from suppliers. But to customers, energy is the same, regardless of who supplies it.[12] If energy is the only good on offer, we would expect competition for customers to be fierce, with each firm trying to offer energy at the lowest possible price to maximise their share of the market.

This doesn't happen in the British market – and lack of consumer engagement, trust and differentiation between providers seem to be the main drivers of the problem. Worryingly, the consumer groups achieving the least value in energy markets are also those who are vulnerable for other reasons: those over age 65, those in social accommodation, those with no qualifications and those on lower incomes.[13] While some parts of the market are competitive, there are areas of serious market failure.

This isn't to say that the industrial and commercial market is perfect. Indeed, there is evidence that microbusinesses,[14] which in some ways have more in common with consumers than with larger firms, are being offered poor value for money. Like consumers, these businesses have relatively few resources available in terms of time, information and expertise to help them research the options available to them in the market, and to track down the best deal. And, like consumers, with relatively low levels of demand, they lack market power. It may be worth considering microbusinesses, as the CMA has, as a separate but equally important group, with its own unique requirements.

WOULD A PRICE FREEZE HELP?

A general price freeze across all supply markets could have significant negative consequences. Although a price freeze might be popular with consumers, alone it wouldn't do anything to fix the underlying problems in Britain's domestic energy market. A price freeze could even lead to higher profits for domestic energy supply companies if wholesale prices fall further. Even if introduced as a cap, which in theory allows price to fall, in practice a single regulated reference price would send a signal which protects suppliers from competitive pressures to reduce consumer costs, and lead to an even less responsive market. The freeze would be likely to lead to a convergence of prices across different suppliers, muting the competition which does exist in the consumer market.

There are also legal complexities. Suppliers are under no obligation to provide energy to the market, so could technically refuse to supply if the price is too low. Additionally, Ofgem has a statutory duty to ensure suppliers can finance their operations. If the price freeze leaves suppliers making a loss, the public may be forced to bail contracts out. The price freeze could be structured on a cost-plus basis, however this would undermine the simplicity of the policy and its political clout.

Furthermore, the freeze could cripple competition in the industrial and commercial supply market. By reducing the ability of suppliers to form flexible contracts with business customers, a freeze could kill off smaller competitors and leave the market with similar problems to the household supply market. A price freeze is regulation of the most intrusive form, trampling even those market mechanisms which are currently working well. At the very least, the areas of the market currently functioning well, particularly the Industrial and Commercial sector, should be excluded from the freeze, on the basis that prices are already competitive and Ofgem have

already ruled no investigation into competition is required. But can we do better than this blunt tool to improve how the market works for consumers?

WHAT COULD REGULATORS LEARN FROM THE BUSINESS MARKET?

Comparing the industrial and commercial and domestic supply markets provides an insight into why the consumer market fails. How can we apply this knowledge to create better policies for the consumer energy market?

1) **Give consumers greater incentives to switch**

   It might be entirely rational for consumers to refuse to engage with the energy market, particularly if switching is time consuming. But policies which help consumers differentiate between providers, and make it easier to switch, could help to increase competition in this market. For starters, providers could better differentiate themselves by providing a wider range of options to consumers. While this may have been difficult in a world where consumers lacked information about the cost of energy, and how it varies over the course of a day, the advent of smart meters and real-time consumer data provides an opportunity for providers to offer innovative products. At present, suppliers are limited to offering four tariffs in the retail market – in sharp contrast to the differentiation seen in the industrial and commercial market. While this limitation is meant to be temporary, to increase transparency and help consumers navigate the market, the regulator must take care to ensure it is not blocking innovation, and that new providers have space to offer novel products as new technologies change the trade-off between consumer information and complexity. Distinctive new entrants could help spur greater competition in the sector, and improve value for consumers, as they have done in the industrial and commercial markets.

2) **Create automated systems which make suppliers compete for domestic customers**

   Even with more information and automated switching tools, the most vulnerable consumer groups may remain unable to negotiate good value in energy markets. In these cases, the regulator may wish to consider how the design of markets could help bring stronger competition to consumers, without the need for them to actively choose. Options may include using consumer data created by the roll out of smart meters to set up a reverse auction, where energy providers bid for the business of consumers. This would create a competitive environment, while saving consumers the leg-work and uncertainty of finding the right provider for them.[15] Though this is an ambitious reform, a similar scheme is already used in the US, suggesting that the concept is viable.[16] More simply, the accurate half-hourly meter readings available through smart meters provide an opportunity for the sector to offer more flexible, transparent and accurate contracts, which could help all consumers derive better value from the market.

CHANGE IN THE WHOLESALE MARKET?

This criticism of the price freeze is not to entirely write-off Labour's energy policy – some components of which have been greeted with enthusiasm by experts such as Professor Dieter Helm.[17] Given the complexity of energy markets, their long investment horizons, technological change and the essential nature of the service, it is reasonable to expect some level of government intervention.

One factor which may be distracting attention from the sources of market failure in consumer markets is the state of Britain's wholesale energy markets. These markets, where suppliers purchase energy with which to serve their consumers, are heavily criticised for lacking transparency and liquidity. It is argued that this lack of transparency makes it impossible to judge if consumers are being offered fair prices or not, and lack of liquidity makes it difficult for smaller competitors to gain a foothold. The lack of liquidity is particularly acute in long-term futures markets, which makes it difficult for smaller supply companies to protect themselves against volatility in input fuel prices. Demand for contracts of this nature is naturally limited, due to the higher risks involved in long term contracts and the credit required to purchase so far in advance, but supply is unable to meet even these needs.

Some market participants have suggested that the reason for this lack of liquidity is that a substantial proportion of energy is traded within the Big Six energy firms who both produce and distribute energy, and never appears on the open market. These vertically integrated firms produce energy, and then sell it straight to their consumer-facing distribution business, without disclosing prices. The internal dealings of these firms reduces the amount of energy which makes it into the voluntary wholesale market, and make it difficult for smaller energy companies to obtain power at competitive prices.[18]

The private nature of these trades also makes it relatively difficult to decipher the prices at which the Big Six suppliers are purchasing wholesale electricity from themselves and how competitive the prices they are offering consumers really are. Evaluation of wholesale prices and retail prices suggests that these practices have driven up the prices retail customers faced, and weakened the link between wholesale and retail energy prices.[19] Vertical integration is not necessarily a problem, and can create efficiencies and cost savings. But the lack of transparency in the way these firms trade makes it harder for small suppliers to enter the market and offer consumers an alternative, and difficult to tell if consumers are being treated fairly.

Government and regulators have already recognised the need to improve transparency in this market, and from March 2014 these large suppliers were ordered to open their finances to greater scrutiny. Suppliers now have to publish the prices at which they trade wholesale power up to two years in advance, and cannot refuse a reasonable request by independent suppliers to buy electricity at this rate. Small energy suppliers suggest that these new rules have helped open up the supply market[20] though some argue that trading "windows" prescribed by current legislation are limiting the flexibility available to smaller energy suppliers. [21]

While the situation in the wholesale market has improved, the market could still be much more transparent. Ofgem's latest regulatory changes should help on this front, and they should be allowed time to bed-in before other routes are explored.[22] If these changes don't lead to significant improvements, there are other options. Labour's proposal for a return to the Pool, where all generators have to sell their energy in an open market, could be a reasonable idea. Alternatively, a similar result could be achieved by ring-fencing the generation and supply activities of vertically integrated firms, and forcing them to trade at arm's length in a transparent way, could be a lower cost way of achieving the same aim. Improving transparency in the wholesale market should make it easier for regulators to assess whether and where suppliers are making excess profits, and secure a better deal for consumers. The biggest failures, however, are in the domestic supply market, and it is here, for now, that attention should focus.

ABOUT THE AUTHOR

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Katie previously worked at the Centre for Economics and Business Research, where she led the global economics team. She has also undertaken economic research for a wide range of companies and public sector organisations.

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ENDNOTES

[1] William Hague MP speaking on Sky News 3/2/2015, transcribed online: http://www.theguardian.com/money/2015/feb/03/energy-prices-bill-william-hague-prices-fuel-costs
[2] The "Big Six" is used to refer to Britain's largest energy suppliers, including British Gas, EDF Energy, npower, E.ON, Scottish Power and SSE.
[3] Data from Cornwall Energy provided to the Competition and Markets Authority, figures relate to July 2014.
[4] Competition and Markets Authority, *Energy market investigation: Updated issues statement*, 18 February 2015 available online https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/404867/Updated_Issues_Statement.pdf
[5] Competition and Markets Authority, Energy market investigation: Updated issues statement, 18 February 2015, available online https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/404867/Updated_Issues_Statement.pdf. Average possible savings were between £158 and £234 a year.
[6] Office of Fair Trading, Ofgem and Consumer and Markets Authority, *State of the Market Assessment*, 27 March 2014, available online https://www.ofgem.gov.uk/ofgem-publications/86804/assessmentdocumentpublished.pdf
[7] Anna Moss and Robert Buckley, *Competition in British business energy supply markets: An independent assessment for Energy UK*, (Cornwall Energy, April 2014), available online http://www.energy-uk.org.uk/publication.html?task=file.download&id=3296
[8] Anna Moss and Robert Buckley, *Competition in British business energy supply market: An independent assessment for Energy UK*, (Cornwall Energy, April 2014), available online http://www.energy-uk.org.uk/publication.html?task=file.download&id=3296
[9] Competition and Markets Authority, *Energy Market Investigation: Summary of hearing with Ofgem on 10 November 2014*, available online https://assets.digital.cabinet-office.gov.uk/media/54bf95f540f0b6158a000010/Summary_of_hearing_with_Ofgem.pdf
[10] Cornwall energy, *Third Party Intermediaries in the Business and Industrial Energy Supply Markets* (2014)
[11] Standard Variable Tariffs (STV) have consistently been more expensive for consumers than non-standard tariffs; *Competition and Markets Authority, Energy market investigation: Updated issues statement*, 18 February 2015 available online https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/404867/Updated_Issues_Statement.pdf
[12] In practice firms may differentiate themselves on the basis of customer satisfaction or other bundled services, like boiler maintenance.
[13] Competition and Markets Authority analysis of GfK survey data, *Competition and Markets Authority, Energy market investigation: Updated issues statement*, 18 February 2015 available online https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/404867/Updated_Issues_Statement.pdf
[14] Microbusinesses are defined as though who either: a) have fewer than ten employees (or their full-time equivalent) and have an annual turnover or balance sheet no greater than €2m; b) consumers no more than 100,000 kWh of electricity per year; or c) consumes no more than 293,000 kWh of gas per year.
[15] For further information on these proposals see Ben Richards, *Bargaining on a Low Income: A better deal for consumers*, Social Market Foundation 2015
[16] Energy Auction House, www.energyah.com, accessed 2 March 2015
[17] Dieter Helm, *Labour's Energy Policies*, October 2013 available online http://www.dieterhelm.co.uk/node/1362
[18] Competition and Markets Authority, *Energy Market Investigation: case studies on barriers to entry and expansion in the retail supply of energy Great Britain*, 18 February 2015, available online https://assets.digital.cabinet-office.gov.uk/media/54e378c7e5274a4511000012/Retail_barriers_to_entry_and_expansion.pdf
[19] Monica Giulietti, Luigi Grossi and Michael Waterson, *Price transmission in the UK electricity market: was NETA beneficial?* Warwick Economic Research Papers No 193 (2009,I University of Warwick), available online: http://wrap.warwick.ac.uk/3558/1/WRAP_Giuletti_twerp_913.pdf
[20] Ofgem, *Wholesale Power Market Liquidity: Interim Report* (18 December 2014), available online: https://www.ofgem.gov.uk/ofgem-publications/92181/liquidityinterimreport2014.pdf
[21] http://www.utilityweek.co.uk/news/uk-wholesale-power-market-is-opening-up-say-small-suppliers/1074792#.VL1Ih0esVqU
[22] OFGEM's "Secure and Promote" licence condition, which came into force on 31 March 2014, should help ensure that all energy companies have access to forward contracts and transparent price information. But, given the nature of forward energy trading, a longer evaluation period is needed to test whether these reforms have been successful.