

243/08 - CMA ENERGY MARKET INVESTIGATION: SUMMARY OF PROVISIONAL FINDINGS AND REMEDIES

MEETING NAME BSC Panel

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Summary This paper provides an overview of the provisional findings of the CMA in respect of its Energy Market investigation. It focuses on those possible remedies that are particularly relevant to the BSC. The paper also highlights Ofgem's proposed third review of industry code governance which considers incremental changes in related areas. The Panel is invited to consider the CMA's provisional findings and remedies, and comment as appropriate.

1. Background

- 1.1 The Competition and Markets Authority (CMA) started its investigation into the energy market in Great Britain in summer 2014.
- 1.2 The CMA must determine whether any feature or combination of features of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK. If so, this constitutes an adverse effect on competition (AEC).
- 1.3 This paper outlines the CMA's summary of provisional findings and its notice of possible remedies (published on 7 July 2015). The full provisional findings report along with 36 appendices is also available on the CMA's website¹.
- 1.4 The CMA invited comments on its possible remedies by 5 August. ELEXON's response to the CMA is included as Attachment A.
- 1.5 As noted by the Panel at its meeting in June, Ofgem is, separately, considering a further review of industry code governance². A summary of Ofgem's proposed review is considered further in Appendix 1.

2. Overview of Findings

- 2.1 The CMA has provisionally found that competition in the wholesale gas and electricity generation markets works well, and the presence of vertically integrated firms does not have a detrimental impact on competition.
- 2.2 It has also found that there is no strong case for returning to the old 'pool' system for the wholesale electricity market.
- 2.3 However, the CMA has found adverse effects on competition in a number of areas. It identifies 24 possible remedies covering wholesale market rules; retail competition and customer engagement; settlement design; Ofgem's duties, objectives and independence and the governance of industry codes.

¹ <https://www.gov.uk/cma-cases/energy-market-investigation>

² <https://www.ofgem.gov.uk/publications-and-updates/open-letter-further-review-industry-code-governance>

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- 2.4 While the CMA finds no evidence to suggest that there is tacit coordination between the domestic retail energy suppliers in relation to price announcements, it does note that widespread consumer disengagement is impeding the proper functioning of the market. In particular, a lack of customer awareness of what deals are available, confusing and inaccurate bills and the real and perceived difficulties of changing suppliers all deter switching. This gives suppliers a position of unilateral market power concerning their inactive customer base and suppliers have the ability to exploit such a position through their pricing policies.
- 2.5 The report notes that, between 2009 and 2013, domestic customers have paid around £1.2 billion (and SME customers paid around £0.5 billion) more per annum than would have been the case had competition functioned more effectively.
- 2.6 The report also points to a lack of transparency that is hampering trust in the sector. It suggests that wider availability of financial information, and more effective communication of the impact of decisions on bills, alongside a clear and transparent demarcation of responsibilities between the Department of Energy & Climate Change (DECC) and Ofgem – and a clearer, independent role for Ofgem – would assist in making sure that policy is efficient, effective and targeted at the right areas.
- 2.7 Regulation and the role of Ofgem feature heavily in the CMA’s concerns including:
- The failure of interventions designed to simplify prices, such as the ‘four-tariff rule’, which have not increased customer engagement and have limited discounting and reduced competition;
 - A lack of a regulatory requirements for clear and relevant financial reporting concerning generation and retail profitability;
 - Concerns over Ofgem’s statutory objectives and duties which, in certain circumstances, may constrain its ability to promote effective competition;
- 2.8 The CMA has suggested remedies that:
- require Ofgem operate an independent price comparison service across the whole market;
 - give Ofgem powers to set a transitional ‘safeguard regulated tariff’ for customers who do not actively choose a new tariff at the end of their existing contract;
 - introduce a formal mechanism through which disagreements between DECC and Ofgem over policy decision-making could be addressed transparently;
 - make code administration and/or implementation of code changes a licensable activity;
 - give Ofgem powers to project-manage and/or control the timetable of the process of developing and/or implementing code changes; and
 - appoint an independent code adjudicator to determine which code changes should be adopted in the case of dispute and grant such an adjudicator Ofgem’s current role approving or refusing code modification proposals.
- 2.9 The following sections highlight the findings and proposed remedies that may be of particular relevance to the BSC Panel. A list of the complete set of proposed remedies is included as Appendix 2.

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3. Market Rules - Absence of locational prices for transmission losses

3.1 The CMA believes the current system of uniform charging for transmission losses creates a system of cross-subsidisation that distorts competition between generators. It is likely to have both short- and long-run effects on generation and demand:

- i) 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 overall for them not to generate, and other plants – which it would be more efficient to use – not generating. Similarly, cross-subsidies will result in consumer prices failing to reflect fully the costs of providing the electricity; and
- ii) In the long run, the lack 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, particularly high-consumption industrial demand.

3.2 Proposed Remedies:

Remedy 1: Introduction of a new standard condition to electricity generators', suppliers', interconnectors', transmission, and distribution licences to require that variable transmission losses are priced on the basis of location in order to achieve technical efficiency:

- This would require a change to the BSC to introduce cost-reflective charging mechanism, for example, in the form of variable Transmission Loss Factors (TLFs) that vary by season and by zone. The proposal echoes a number of BSC Modifications that have previously been considered and rejected³.

4. Electricity Settlement – the absence of a firm plan for moving to half-hourly settlement

4.1 The CMA is concerned that the Non Half Hourly Settlement (achieved using profiled consumption) distorts suppliers' incentives to encourage their customers to change their consumption patterns. For example, not incentivising the introduction of new products such as time-of-use tariffs⁴. The CMA contends that this reduces the efficiency and, therefore, the competitiveness of domestic retail electricity supply.

4.2 The CMA notes that Smart meters should remove the need for profiling in electricity. However, there are currently no concrete proposals for using half-hourly consumption data in the settlement of domestic electricity customers (even after the full roll-out of smart meters).

³ P198 – Introduction of a Zonal Transmission Losses scheme (raised December 2005, rejected July 2008); P200 – Introduction of a Zonal Transmission Losses scheme with Transitional Scheme (raised April 2006, rejected July 2008); P203 – Introduction of a seasonal Zonal Transmission Losses scheme (raised June 2006, rejected July 2008); P204 – Scaled Zonal Transmission Losses (raised July 2006, rejected July 2008); and P229 – Introduction of a seasonal Zonal Transmission Losses scheme - essentially same solution as that proposed by P203 'Introduction of a seasonal Zonal Transmission Losses scheme', except that it includes provision for offshore nodes - raised November 2008, rejected September 2011). In rejecting P229, the Authority noted that 'on balance, the implementation of either of the P229 modification proposals would better facilitate the achievement of the applicable objectives of the BSC although we consider that P229 Proposed better facilitates relative to P229 Alternative; but that on balance, directing that either of the modifications be made would not be consistent with the Authority's principal objective and statutory duties.'

⁴ The CMA notes that DECC, drawing on the results from several trials, has estimated that domestic peak load shifting through time-of-use tariffs could be expected to generate present value savings of the order of £900 million through reducing the need for investment in generation (the majority of savings) and the distribution network.

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4.3 Proposed Remedies:

Remedy 13: Require that domestic and SME electricity suppliers and relevant network firms agree a binding plan for the introduction of a cost-effective option to use half-hourly consumption data in the settlement of domestic electricity meters:

- This remedy would seek to ensure that, within a reasonable timetable, half-hourly (HH) consumption data could be used by domestic and SME electricity suppliers to settle electricity for customers falling into profile classes 1 to 4;
- The proposal has implications for work being considered elsewhere (including under Ofgem's proposed Code Governance Review) regarding the co-ordination of industry change; and
- It is not clear how this requirement would be created or enforced. However, delivery could build on the work of the Profiling and Settlement Group (PSRG) and the new Settlement Reform Advisory Group (SRAG) established by the BSC Panel⁵. The SRAG is currently looking to enable HH settlement for smart meters. The Panel may wish to instruct the SRAG to undertake further work in this area based on the CMA's proposed remedy.

5. Industry Codes

Parties' conflicting interests and/or limited incentives to promote and deliver policy changes

5.1 While praising Ofgem's Code Governance Review, the CMA observes that the existing governance and modification arrangements can lead to inconsistent or delayed outcomes. It is concerned that current governance can create material burdens on parties (in particular smaller parties) which could undermine their incentives to promote changes.

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

5.2 The CMA's central concern is that the limited ability of Ofgem to influence development and implementation processes might cause certain changes that are in consumers' interest not to be delivered in a timely and efficient way. The CMA cites Project Nexus as a particular example.

5.3 Proposed Remedies:

Remedy 18a: Recommendation to DECC to make code administration and/or implementation of code changes a licensable activity:

- By making the roles of code administration and delivery of code changes a licensable activity, this remedy would give Ofgem the power to efficiently monitor performance of code administrators, give them directions and impose sanctions when appropriate. The CMA expects that this would also lead to more consistency between governance and modification arrangements across codes and improve outcomes for consumers by:
 - accelerating the process of developing changes to the codes; and

⁵ The SVG established the Profiling and Settlement Review Group in 2010. The PSRG's remit was to review how to adapt profiling and Settlement processes to the use of advanced and smart Meters in the Non Half Hourly market, focusing on improvements within a 10-year timeframe. The PSRG reported to the SVG on a number of potential Settlement improvements. These included Half Hourly Settlement, reducing Settlement timescales and settling dynamically-switched smart Meters. The PSRG provided a number of recommendations concerning [mandatory HH Settlement for PC1-4 Meters](#). The new Settlement Reform Advisory Group (SRAG) will continue work on Settlement reform under the Panel's oversight.

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- making the initiation and development of modification proposals more efficient (including within the context of cross-code modifications);
- It is not clear that such regulatory oversight would provide material benefits compared to the status quo under the BSC (which affords Ofgem/the Authority considerable powers to dictate the pace of change and, if necessary, direct that National Grid step in to deliver the Modification process in the event that BSCCo or the Panel does not comply with the provisions of the BSC⁶). It is also unclear how the application of sanctions (e.g. the application of penalties imposed under a licence) would be compatible with BSCCo's present funding arrangement as a not-for-profit entity, which we believe supports the delivery of impartial services in line with BSCCo's obligations;
- This proposal has other significant implications and considers whether Ofgem or DECC should impose stricter requirements relating to the selection (e.g. competitive tender), financing and/or independence of code administrators (and/or delivery bodies);
- It may also involve transferring certain functions currently carried out by code panels (eg setting up working groups) to code administrators; and
- It would require the creation of new licences and the re-engineering of existing licence and industry code structures.

Remedy 18b: **Granting Ofgem more powers to project-manage and/or control timetable of the process of developing and/or implementing code changes:**

- By granting Ofgem powers to intervene directly in the development and/or implementation of code changes, Ofgem would be able, when it deems it necessary, to pursue consumers' interests, to project-manage code modification processes, or at least their timetable. This would complement Ofgem's existing powers (e.g. 'significant code review') by allowing Ofgem, in the context of ongoing modification proposals, to take over certain functions from, or mandating certain action to, relevant bodies. As a result, Ofgem could ensure key modification proposals that further consumers' interests are developed and implemented in a timely and efficient manner; and
- It might be that the current provisions in the BSC (which enable the Authority to limit the Modification Assessment timetable and request revised implementation dates) are deemed sufficient. However, the CMA appears to envisage more extensive powers for Ofgem to intervene directly in the development and implementation of code changes in a way that complements existing powers under 'significant code reviews'.

Remedy 18c: **Appointment of an independent code adjudicator to determine which code changes should be adopted in the case of dispute:**

- By appointing and giving appropriate powers to an independent code adjudicator, this remedy would aim to resolve disagreements between parties over code changes more quickly than is currently the case. The CMA envisages an independent code adjudicator would need to be granted Ofgem's current role to approve or refuse code modification proposals. A code adjudicator would also need to powers to control the development and/or implementation of code changes (as envisaged for Ofgem under Remedy 18b); and
- The CMA considers that an independent adjudicator would be impartial but queries whether there are benefits in terms of independence, impartiality and/or industry know-how of an independent code

⁶ BSC Section F

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adjudicator not currently available with Ofgem. It is concerned that an additional body may adversely impact coordination between code modification governance, licence modifications and legislation.

6. Ofgem's duties and objectives and independence

- 6.1 The CMA also comments on Ofgem's duties, objectives and independence. The CMA's observations and recommendations in respect of Ofgem's statutory duties may also be of interest to the BSC Panel.
- 6.2 The CMA notes a significant concern that Ofgem considers its current duties impose a constraint on its ability to pursue competition-based policies. The CMA states that that changes made in the Energy Act 2010 to Ofgem's statutory objectives and duties may have led Ofgem to carry out inefficient trade-offs between competing objectives. This in turn might have led to decisions that adversely impact competition.
- 6.3 Remedy 16 proposes that Ofgem's statutory objectives and duties should be revised in order to increase its ability to promote effective competition. In this context, the CMA queries what changes may be required to Ofgem's statutory objectives and duties.

7. DECC's response to the CMA provisional findings

- 7.1 DECC published its response to the CMA provisional findings in a letter from Amber Rudd ([31 July](#)). DECC welcomes the findings and notes *'You have undertaken an impressive amount of analysis over the past year and the detail of the Provisional Findings document is testament to this'*. Points to note that are relevant to the BSC are:
 - a) Industry governance and industry codes: with DECC commenting that it is pleased that the CMA is looking in this area as this area *'has escaped detailed scrutiny over recent years'*. Also DECC will consider closely the points made on the interaction with DECC and Ofgem. This supports our view of improvements to cross code change co-ordination and better code administration;
 - b) Half Hourly settlement for domestic customers. DECC is interested in the CMA findings and agrees about the importance of half hourly settlement in facilitating greater innovation in time of use tariffs. DECC also states that they will shortly be bringing forward proposals that will seek to give Ofgem greater powers in order to deliver settlement reform more quickly. The Panel may wish to consider how the work of the SRAG could feed into this process; and
 - c) DECC working with Ofgem on next day switching. As noted to the Panel, we are supporting this programme of work (expert support to industry groups and later in the year to the various design working groups) and through the chair and expert support to the Address Data Working group.

8. Next Steps

- 8.1 The CMA has indicated it may seek further detailed discussions with interested parties on the findings and possible remedies as it moves to publish its final report by the end of the year.
- 8.2 The deadline for comments to be provided to the CMA in relation to its provisional findings has passed. However, we have noted to the CMA, at the Panel's request, that the Panel may wish to provide its views on the provisional findings in due course.
- 8.3 The findings regarding regulation and industry code governance in particular are likely to inform any work progressed under Ofgem's proposed review of industry code governance. However, Ofgem has indicated that its review will focus on incremental change rather than the more fundamental changes contemplated by the CMA. Ofgem has indicated it will issue a further consultation on its proposals in late summer.

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9. Recommendations

9.1 We invite you to:

- a) **COMMENT** on the CMA's provisional findings and its notice of possible remedies of its energy market investigation.

Appendices

Appendix 1 – Summary of Ofgem's proposed review of industry code governance

Appendix 2 – List of all remedies proposed by the CMA

Attachments

Attachment A – ELEXON's Response to the CMA's provisional findings and notice of possible remedies

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APPENDIX 1 - SUMMARY OF OFGEM'S PROPOSED REVIEW OF INDUSTRY CODE GOVERNANCE

1. Background

- 1.1 Ofgem's first code governance review ran from 2007 to 2010 and resulted in the Code Administration Code of Practice and the concept of code administrators as critical friends, the Self Governance process and the Significant Code Review process. Outside the BSC the review also gave rise to revised governance for certain charging methodologies. (These include the gas and electricity transmission connection and use of system network charging methodologies and the gas distribution use of system network charging methodologies. Subsequently, the electricity distribution charging methodologies were also brought into industry code governance).
- 1.2 The second code governance review concluded in 2013 and extended these reforms to cover all of the industry codes.

2. Code Governance Review 3

- 2.1 Ofgem published an open letter on 15 May 2015 expressing concern that, while the reforms introduced under the first and second code governance reviews have improved the code governance arrangements, challenges remain. These include:
 - difficulties in the delivery of beneficial change through code modifications;
 - concerns about the quality of industry analysis on complex change;
 - risks associated with lack of co-ordination across codes;
 - difficulty driving through change where there may be industry opposition through a lack of incentives for industry to engage in the change process;
 - difficulty experienced by smaller parties in engaging in the code change processes; and
 - concerns that the arrangements are a barrier to entry.
- 2.2 In order to address these challenges, Ofgem is contemplating changes in relation to:
 - Significant Code Reviews
 - Code administration requirements
 - Self-Governance processes; and
 - Charging methodologies
- 2.3 Ofgem presented its latest thinking and sought additional views at a workshop held on 22 July. Ofgem has proposed that a third code governance review might consider:
 - **Significant Code Reviews:** Ofgem is considering whether there are changes that would enhance the process. At the workshop held on 22 July, Ofgem shared two straw-man proposals. The first straw-man suggested powers for Ofgem to direct the timetable for Modifications, the second suggested that the Modification process be absorbed into the SCR (i.e. detailed change development and assessment becomes part of the SCR programme).
 - **Code Administration:** Ofgem is considering how code administrators and the wider industry could operate in a more proactive and strategic way in their management of the code modification processes. This aligns with recent work by the BSC Panel regarding its Panel Strategy, and its review of its role and

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functions. Ofgem has highlighted potential areas for improvement, including: delivery of critical friend obligations (particularly with respect to engaging with small parties), code panel composition (a call for independent members on all code panels), more consistency across code panels/administrators in interpreting the principles of the CACoP (including the assessment and co-ordination of change) and identification of consumer impacts.

- **Self-Governance:** Ofgem is seeking more use of the self-governance provisions. It has suggested that one option might be that, in future, all changes be self-governance by default and that code panels would then have to make the case that a change was material enough to warrant an Ofgem decision.
- **Charging methodologies:** Ofgem has queried whether there should be a bigger role for code administrators in a pre-modification process and whether modification windows should be introduced to allow a more focused and planned approach to assessing charging modifications.

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APPENDIX 2 – CONSOLIDATED LIST OF PROPOSED REMEDIES (FOR REFERENCE)

Wholesale Market Rules

Remedy 1: Introduction of a new standard condition to electricity generators', suppliers', interconnectors', transmission, and distribution licences to require that variable transmission losses are priced on the basis of location in order to achieve technical efficiency

Remedy 2a: DECC to undertake and consult on a clear and thorough impact assessment before awarding any CfD outside the CfD auction mechanism

Remedy 2b: DECC to undertake and consult on a clear and thorough assessment before allocating technologies between pots and the CfD budget to the different pots

Retail Competition and Customer Engagement

Remedy 3: Remove from domestic retail energy suppliers' licences the 'simpler choices' component of the RMR rules

Remedy 4a: Possible measures to address barriers to switching by domestic customer

Remedy 4b: Removal of exemption for Centrica on two-year inspection of gas meters

Remedy 5: Requirement that energy firms prioritise the roll-out of smart meters to domestic customers who currently have a prepayment meter

Remedy 6: Ofgem to provide an independent price comparison service for domestic (and microbusiness) customers

Remedy 7a: Introduction of a new requirement in the licences of retail energy suppliers to provide price lists for microbusinesses on their own websites and to make this information available to price comparison websites

Remedy 7b: Introduction of rules governing the information that third party intermediaries are required to provide to microbusiness customers

Remedy 8: Introduction of a new requirement into the licences of retail energy suppliers that prohibits the inclusion of terms that permit the auto-rollover of microbusiness customers on to new contracts with a narrow window for switching supplier and/or tariff

Remedy 9: Measures to provide either domestic and/or microbusiness customers with different or additional information to reduce actual or perceived barriers to accessing and assessing information

Remedy 10: Measures to prompt customers on default tariffs to engage in the market

Remedy 11: A transitional 'safeguard regulated tariff' for disengaged domestic and microbusiness customers

Settlement Design

Remedy 12a: Requirement to implement Project Nexus in a timely manner

Remedy 12b: Introduction of a new licence condition on gas shippers to make monthly submissions of Annual Quantity updates mandatory

Remedy 13: Requirement that domestic and SME electricity suppliers and relevant network firms agree a binding plan for the introduction of a cost-effective option to use half-hourly consumption data in the settlement of domestic electricity meters

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Ofgem's duties and objectives and independence

Remedy 14: Remedy to improve the current regulatory framework for financial reporting

Remedy 15: More effective assessment of trade-offs between policy objectives and communication of impact of policies on prices and bills

Remedy 16: Revision of Ofgem's statutory objectives and duties in order to increase its ability to promote effective competition

Remedy 17: Introduction of a formal mechanism through which disagreements between DECC and Ofgem over policy decision-making can be addressed transparently

Industry Codes

Remedy 18a: Recommendation to DECC to make code administration and/or implementation of code changes a licensable activity

Remedy 18b: Granting Ofgem more powers to project-manage and/or control timetable of the process of developing and/or implementing code changes

Remedy 18c: Appointment of an independent code adjudicator to determine which code changes should be adopted in the case of dispute

Discarded Remedies

The CMA considered (and discarded) the following remedies:

- Price control regulation of all domestic and microbusiness retail energy tariffs;
- Requiring energy firms to inform customers about the cheapest tariff on the market (across all suppliers);
- Opt-out collective switching of disengaged customers (where customers who have not engaged in the market in a given period of time (such as five years) are automatically included in an auction process unless they specifically opt out);
- Introduction of a single price for gas and electricity customers;
- Introduction of price non-discrimination provisions; and
- A transitional safeguard regulated price structure.