

Project Manager
Energy market investigation
Competition and Markets Authority
Victoria House
Southampton Row
London
WC1B 4AD

14 August 2014

Dear Sir / Madam

Initial submission in response to “Energy Market Investigation: Statement of Issues”

Citizens Advice and Citizens Advice Scotland hold statutory responsibilities to represent energy consumers in accordance with the Consumers, Estate Agents and Redress Act 2007.

This submission provides our response to the Statement of Issues published on 24 July 2014. It is entirely non-confidential and may be published on your website.

We welcome the statement of issues produced by the CMA and are largely in agreement that the issues highlighted within it provide an appropriate basis for the investigation. We would however like to see the inclusion of a theory of harm relating to network costs – both in relation to their magnitude and the manner in which they are passed through to suppliers. We would also like to make some observations on the characteristics of the market. We cover these issues in detail in the remainder of this letter.

Theory of harm

Changes to network costs have frequently been cited as one of the causal factors for cost price inflation in end consumer prices, though the magnitude of their contribution has been disputed.

We would like the CMA to re-consider its decision to exclude from the scope of the investigation the regulation of revenues earned from transmission and distribution. We consider there to be prima facie evidence that energy price control settlements have tended to over reward the providers of monopoly network infrastructure and that this should be tested as a theory of harm.

Networks are natural monopolies. Consumers rely on regulation to set a level of return that adequately encourages the necessary investment in these essential services while being proportionate to the level of risk associated with that investment and the performance of the businesses involved.

Investors have a choice of where to put their money, so it is worth considering the alternatives available to them when looking at the level of return that is proportionate to encourage investment in the sector. The long-run real rate of return on UK equities is in the region of 5 to 6%, although this has declined to 1.2% thus far this centuryⁱ.

In any investment decision, it is reasonable to expect risk and reward to be linked. There are a number of factors that make energy networks a lower risk than most other companies:

- First, they are monopolies; there is no risk of predation of their customers;
- Secondly, there are statutory safeguards in place to ensure that they can cover their cost of debtⁱⁱ. No such safety net exists for a typical company in most sectors;
- Thirdly, there are a range of uncertainty mechanisms contained within price control processes, including the scope for mid-review points, which allow for further business uncertainty to be stripped out; and
- Fourthly, the nature of the regulated settlement and of the commodity itself (an essential service) means that returns are relatively inelastic and comparatively immune to economic boom & bust cycles.

These factors suggest that energy network companies are engaged in a low risk economic activity. One might therefore expect a low level of reward to be the norm. It would appear intuitive that baseline returns would be set at a discount to average equity returns, reflecting this lower than average risk. In fact, the baseline returns allowed to energy networks under the current regulatory settlements tend to be higher than average equity returns, and even higher than those that are realised by materially higher risk economic activities.

In addition to (or subtracted from) their baseline revenues, networks can achieve higher (or lower) returns depending on their performance against a range of incentives and penalties. One might expect to see a range of performance resulting in a scattering of outcomes either side of the baseline return, reflecting some networks outperforming and some underperforming. In fact, 'outperformance' is the norm. There is strong evidence that the combination of rewards and penalties, while theoretically symmetric, is in practice upside-only for the networks. Double-digit returns are frequent. In the last completed electricity and gas transmission price controls, every single network outperformed its base allowed return; in the last completed gas distribution price controls, every single network outperformed its base allowed return; and in the first year of the current electricity distribution price control, every single network outperformed its base allowed returnⁱⁱⁱ. Their performance figures are shown in the annex to this letter.

As well as the overall trend of network costs, the manner in which these are sculpted and notified has the potential to impact on final consumer costs. The Energy and Climate Change Committee has received evidence from several small suppliers^{iv} that late notification of network charging, and year-on-year volatility in the level of these charges, creates unnecessary risk in operating a supply business. This could increase barriers to entry in the retail supply market and thus adversely affect end consumer prices.

The characteristics of the market

We recognise and agree with the key characteristics of the market set out in paragraph 16, although it is not exhaustive. We suggest it also has the following characteristics.

Energy is an essential service. The market has to serve all consumers, because all consumers have a need for this product. Consumers do not have the option of ‘walking away’ from the market if they cannot find the product they need.

Extremely low levels of public trust. Public trust in the UK energy sector is abnormally low both compared to other sectors in the UK and to the same sector in other countries^v.

Energy price inflation is outstripping wage growth, and affordability is a major issue. The average dual fuel bill household bill increased by 112% between January 2005 (£594) and January 2014 (£1,257) even after allowing for reductions in the average level of consumption in that time^{vi}. The fuel poverty gap, the amount by which the assessed energy needs of fuel poor households exceed the threshold for reasonable costs, is widening in England^{vii}. The number of households in Wales in fuel poverty is growing, and its fuel poverty gap is also widening^{viii}. While fuel poverty figures are improving in Scotland, more than a quarter of its households (27.1%) remain fuel poor^{ix}. In all nations, fuel poverty figures are at unacceptable levels.

Standards of service are often poor, and appear to be deteriorating. Complaints to the Energy Ombudsman are at an all-time high^x. Citizens Advice analysis of supplier complaints at the Big 6 suggest these increased by more than half in 2013^{xi}. One supplier is currently receiving the highest level of complaints we, or our predecessor body Consumer Focus, has ever recorded^{xii}. Citizens Advice Bureaux in England and Wales received 49,142 contacts in relation to fuel issues in 2013/14 – a 21% increase on the preceding year (40,560)^{xiii}. In Scotland, the total number of energy issues brought to bureaux in 2012/13 was 9,869, a 4% increase on the previous year (9,500). In a September 2013 YouGov poll, 56% of people agreed that “energy companies treat people with contempt” while only 7% disagreed^{xiv}.

Consumers do not have a good understanding of how their bill is made up. Polling conducted by MVA for Consumer Focus in 2012 suggested that 67% of the public were unaware that social and environmental obligations were paid for through their bills. In separate deliberative workshops conducted as part of the same project, it was found that consumers had little awareness of the proportion of their bills that was attributable to social and environmental policies^{xv}. While it is likely that knowledge of levies will have increased, at least to some extent, due to the very public disputes over these costs that arose in autumn 2013 it may not follow that understanding of the relative contribution of these costs has also increased.

There are structural barriers to some customers accessing some products. The best deals tend to be fixed term deals paid for by direct debit. Over 13% of households, containing around 9.6 million people, pay for energy through prepayment meters. To access the best deals these consumers may need to pay and arrange for their meters to be replaced. The 1.87 million households with teleswitched meters, and 550,000 households with dynamically teleswitched meters, may similarly lack choice. Around 700,000 people live in households where no-one has a bank account at all, while some basic bank accounts do not allow direct debit payments. 17% of the population do not have internet access^{xvi}, which may impede effective price comparison given tariff complexity. Following Ofgem’s Retail Market Review

reforms, most suppliers have withdrawn zero standing charge tariffs which may disadvantage low users. Consumers in remote or rural areas are less likely to have access to mains gas, which is usually the cheapest form of heating, are less likely to benefit from social and environmental obligations like ECO than those in urban areas^{xvii}, and are more likely to live in a less thermally efficient home^{xviii}. In addition, lower income groups are more likely to be unable to access the gas grid than higher income groups^{xix}.

Suppliers are subject to policy obligations to destroy their own market. The principal delivery mechanism for demand reduction in Great Britain has been supplier obligations, in the past EEC, CERT & CESP, now the Energy Company Obligation. Suppliers are therefore subject to both commercial incentives to sell more, and statutory obligations to sell less, energy. This may result in sub-optimal delivery outcomes for consumers. It may also result in competitive distortion, insofar as some suppliers are exempt from policy costs while others are not.

Priorities for the inquiry

From these characteristics, and those already detailed by the CMA, we would like to draw out two particular points on which we think you must be particularly mindful during your work.

The first is around public understanding and trust in the sector. The cost drivers behind price movements have been a source of near-constant public dispute for many years now, with the result that the vast majority of consumers, rightly or wrongly, simply no longer believe what energy companies have to say on the issue. A one-off conclusion that prices are, or are not, fair is unlikely to prevent the recurrence of dispute if the protagonists can simply dismiss it as outdated by subsequent events. So it is vitally important that the CMA's inquiry leaves behind a structural framework that can give the public enduring confidence that they are not being ripped off. If you cannot deliver this, your inquiry will have failed.

The second is on the essential nature of the service. Energy is not a luxury, therefore the market must work for all sectors of society. In essential services, there is always a risk that some competitive outcomes may clash with wider public policy objectives. For example, we recognise that the poorest consumers may sometimes be the most expensive to serve; it may therefore follow that a conclusion is reached that it is cost-reflective to charge them more for their energy. This may be a logical competitive outcome but it would not sit comfortably with wider public policy aspirations to reduce fuel poverty, or to protect vulnerable consumers. It is quite possible that improvements in the competitive landscape will help all consumers in the energy market. But, if your study suggests that the market will simply never wish to serve some consumers, or that it is unrealistic to think that some vulnerable consumers will ever be able to engage effectively with the market, we would encourage you to think seriously about what recommendations you can make to Government to help those consumers mitigate their financial distress. If your inquiry leaves some groups of customers behind it will also have failed.

Citizens Advice, Citizens Advice Scotland and their predecessor bodies Consumer Futures and Consumer Focus have conducted an extremely wide range of research into the experiences of consumers in the GB energy market over a number of years. We would welcome an early discussion with your team on any areas where you think we may be able to provide you with data or past research that is relevant to your enquiry.

If you would like to discuss any of the matters raised please direct your query in the first instance to Richard Hall (richard.hall@citizensadvice.org.uk, 03000 231354).

Yours faithfully

[unsigned as sent via email]

Richard Hall
Director of Strategic Infrastructure
Citizens Advice

Sarah Beattie-Smith
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Annex – performance of electricity and gas networks against base revenue

Transmission Network returns in last completed price control (TPCR4 and TPCR4RO, 1 April 2007 to 31 March 2013)^{xx}

Company	NGET TO	SHE	SPTL	NGGT TO
Allowed revenue (baseline return on regulated equity)	7.0%	7.0%	7.0%	7.0%
Total return on regulated equity achieved including all incentives	9.2%	9.9%	10.1%	7.4%
Outperformance versus baseline return.	2.2%	2.9%	3.1%	0.4%

Gas Distribution Network returns in last completed price control (GDPCR1, 1 April 2008 to 31 March 2013)^{xxi}

Region	EoE	Lon	NW	WM	NGN	Sc	So	WWU
Allowed revenue (baseline return on regulated equity)	7.25%	7.25%	7.25%	7.25%	7.25%	7.25%	7.25%	7.25%
Total return on regulated equity achieved including all incentives	8.35%	8.19%	8.88%	9.21%	11.18%	9.72%	10.10%	10.14%
Outperformance versus baseline return.	1.10%	0.94%	1.63%	1.96%	2.93%	2.47%	2.85%	2.89%

Electricity Distribution Network returns in first year of current price control (DPCR5, 1 April 2010-11)^{xxii}

Region	SSES	NPG N	SSEH	NPG Y	Swales	SWest	SPM W	ENW L	LPN	EMID	WMI D	SPD	SPN	EPN
Allowed revenue (baseline cost of equity)	6.7%	6.7%	6.7%	6.7%	6.7%	6.7%	6.7%	6.7%	6.7%	6.7%	6.7%	6.7%	6.7%	6.7%
Return on regulated equity achieved, allowing for Totex and other main variables	14.64 %	14.26 %	13.84 %	13.27 %	13%	12.15 %	10.88 %	10.45 %	10.43 %	10.04 %	9.04 %	8.79 %	6.78 %	6.74 %
Outperformance versus baseline return.	7.94 %	7.56 %	7.14 %	6.57 %	6.3%	5.45 %	4.18 %	3.75 %	3.73 %	3.34 %	2.34 %	2.09 %	0.08 %	0.04 %

ⁱ The annualized real return on UK equities from 1900-2013 was 5.3%; from 1964-2013 was 6%; and from 2000-2013 was 1.2% (source: Credit Suisse Global Investment Returns Yearbook 2014).

ⁱⁱ Amongst Ofgem's statutory duties is the need to secure that network licence holders are able to finance their activities (See sections 3A of the Electricity Act 1989 (as amended) and 4AA of the Gas Act 1986 (as amended)).

ⁱⁱⁱ This data covers the year 1 April 2010 to 31 March 2011. To the best of our knowledge, at the time of writing this is the most recent year on which Ofgem has provided an aggregated summary of networks financial performance.

^{iv} See submissions by Haven Power <http://tinyurl.com/n8rfnph> and First Utility <http://tinyurl.com/kk7634e>.

^v The 2014 Edelman Trust Barometer found that the UK has the highest incidence of public distrust in the energy industry of any country surveyed, with a net trust percentage of -23% compared to a global average of +32%. It was the joint least trusted sector in the UK, alongside banks. <http://tinyurl.com/lzx2fuc>

^{vi} Citizens Advice analysis <http://tinyurl.com/khdh22r>

^{vii} 'Fuel Poverty Report - updated August 2013,' DECC. <http://tinyurl.com/mprvk47>

^{viii} Source: 'Wales Fuel Poverty Projection Tool: 2011/12 Report,' 2013, Welsh Government. <http://tinyurl.com/q3koox9>

^{ix} Source: 'Scottish House Conditions Survey 2012: Key Findings,' The Scottish Government. <http://tinyurl.com/lml1768>

^x The Energy Ombudsman received 22,671 complaints regarding energy companies during the first half of 2014 – more than during the entirety of 2013. Monthly complaints in June 2014 were the highest on record. Source: 'Energy Ombudsman releases half year complaints figures,' Ombudsman Services. <http://tinyurl.com/nzn4omo>

^{xi} From 54.4 (January) to 88.7 (December) per 100,000 customers. Source: 'npower most complained about supplier in 2013,' Citizens Advice, 13 May 2014 <http://tinyurl.com/mqnk2x5>

^{xii} npower.

^{xiii} There were increases in price and tariff issues (+14%), switching supplier (+35%), billing/meter issues (+25%) and selling methods (+16%).

^{xiv} 'Voters: energy prices are number one threat,' YouGov, 25 September 2013 <http://tinyurl.com/qbjq3jq>

^{xv} 'Who Pays? Consumer attitudes to the growth of levies to fund environmental and social energy policy objectives,' Consumer Focus, 2012. <http://tinyurl.com/k372rrc>

^{xvi} Source: 'Internet access: households and individuals 2013,' 8 August 2013, Office for National Statistics. <http://tinyurl.com/lgdahk9>

^{xvii} Installation of ECO measures in the first year of that scheme suggests that delivery is skewed towards urban areas and towards homes heated by gas. Although more than 20% of homes are in rural areas, only 7.5% of ECO measures had been installed in rural homes.

Source: 'The ECO: an evaluation of year 1,' 2014, The Centre for Sustainable Energy. <http://tinyurl.com/m2oabcp>

^{xviii} Homes reliant on non-gas heating fuels have much lower energy efficiency standards than gas heated homes. 60 per cent of non-gas heated homes in Wales, 49 per cent in England and 22 per cent in Scotland are F and G rated on the Energy Performance Certificate scale compared to less than 10 per cent of gas-heated homes. While this reflects the higher heating costs associated with these fuels it is also a result of condition of the off gas homes. Off gas homes have a greater likelihood of being older, detached and built with solid walls.

Detached homes and bungalows account for 60 per cent of all homes with oil heating in England, 52 per cent in Wales and 71 per cent in Scotland compared to 31 per cent of all homes in Britain; Homes heated by oil and solid fuel are more likely to have solid walls than homes using other heating fuels. 33 per cent of oil-heated homes in England, 47 per cent in Scotland and 35 per cent in Wales have solid walls, in comparison to 25 per cent of homes in Britain as a whole. Homes using oil and LPG as their main heating fuel are also much more likely to use secondary heating compared to homes using other fuels. Source: 'Off-gas consumers: information on households without mains gas heating,' October 2011, Consumer Focus. <http://tinyurl.com/6et3txu>

^{xx} 'Off-gas consumers: information on households without mains gas heating,' *ibid*.

^{xx} Source: 'Transmission networks: report on the performance of Transmission Owners during the regulatory periods TPCR4 & TPCR4RO, 2007-08 to 2012-13,' Ofgem, 21 March 2014. <http://tinyurl.com/pfm7md2>

^{xxi} Source: 'End of period review of the First Gas Distribution Price Control (GDPCR1),' Ofgem, 21 March 2014. <http://tinyurl.com/nvhsy7v>

^{xxii} Source: 'Electricity Distribution Annual Report for 2010-11,' Ofgem, 30 March 2012. <http://tinyurl.com/kzw5sdm>