Competition and entry in the GB electricity retail market
A REPORT PREPARED FOR ENERGY UK

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# Competition and entry in the GB electricity retail market

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Competition and entry in the GB electricity retail market

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Executive Summary

The electricity retail market was liberalised over ten years ago. Interest in this market has increased over the last few years, with some suggesting that competition is not fully effective. We were asked to provide an independent view about the level of competition in this market, and provide options that could be taken to promote further entry. We believe that the market is competitive. However, as we would expect in a market that is characterised by high risk, a large capital requirement and substantial Government and regulatory intervention, some barriers to entry remain. Although there are actions that could increase entry, they often distort the market and have an associated cost. Policy makers therefore need to be sure that the benefit from new entry can reasonably be expected to exceed all costs that may come with its promotion.

Both Government and Ofgem have completed detailed investigations of the electricity retail market in recent years. Neither found any evidence of collusion in the market. Further, the returns the companies were making were often low and sometimes negative. Competition in this sector, both by number of suppliers and customer switching rates, also compares favourably with the rest of Europe. However, although there has been new entry, barriers preventing new suppliers entering and expanding were identified by Government and Ofgem. In addition, Ofgem is currently undertaking a further review of the market1.

Any assessment of this market must be seen in the context of the change that the energy sector is undergoing. An estimated £200bn of investment is needed to deliver the dual challenge of decarbonisation and delivering security of supply over the next 10 to 15 years2. To understand the future of competition in this market, we need to understand what we expect suppliers’ role to be in delivering this vision. If Government wishes to use suppliers to deliver policy, it needs to recognise that entry into this market may well become harder.

Our view is that price competition in this market is strong and we have seen no evidence that it is failing to deliver the efficient provision of retail services to customers. Suppliers have also been active in delivering innovation. However, it is important that the pressure to

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1 “Ofgem to review the effectiveness of the retail energy market to see if further action is needed to protect consumers”, Ofgem (26 November 2010).

2 Speech by Charles Hendry to the Fuellers lecture 25th Anniversary (20 September 2010).
innovate remains strong, particularly following the imminent roll-out of smart meters and the increased opportunities that this could bring.

As expected in a market with the characteristics of electricity retail, there are barriers to entry particularly for smaller suppliers. Further, there are not many “easy wins” in terms of lowering these barriers. Instead there will be an associated cost connected with reducing them. Clearly any policy change that comes with a cost should be pursued only if there is sufficient certainty that it will deliver a more than compensatory benefit. Policy makers should therefore be sure that there is a sufficient case for sacrificing some static efficiency to increase entry on the basis that this will deliver more dynamic efficiency in future.

In our view, the main barriers, and options to reduce them, include the following.

- **Dealing with Government policy and regulatory intervention:** Government has increasingly used suppliers to deliver policy, both to meet environmental objectives and social obligations. The number of policies, and their cost and complexity, has grown rapidly. These act as a barrier to entry and growth, particularly for smaller suppliers that reach the thresholds for participation. Further, as these requirements have increased, the importance of competition seems to have been downgraded. There are an increasing number of regulations that essentially limit competition between suppliers. One of the most commented-upon examples is the introduction of the non-discrimination licence provisions in 2009. Ofgem should review the impact of these regulations as part of its current retail market investigation given that their impact is likely to have weakened competition. Reform of this policy is not only an easy win, but should also be a pre-requisite to any further action to reduce other barriers to entry since other options to promote competition are likely to come with higher risks and costs associated with them.

- **Liquidity:** The recent focus on liquidity being the biggest barrier to entry may have been over-played. However, it is the case that smaller suppliers have found less liquidity for tailored “shaped” products of a small clip size that match their retail portfolio. The recent evidence is that this may be changing: the products and volumes available on exchanges are continuing to increase and
industry initiatives to take positive steps to increase liquidity have been announced\(^3\). As Ofgem also notes in its recent update on liquidity\(^4\), we believe there is a clear benefit to giving these positive initiatives a chance to take hold before seeking further interventions, given that any further interventions are not without costs and risks.

- **Credit risk:** The requirements for collateral to cover credit risk are a problem for smaller, less well capitalised players that do not have a credit rating. This is difficult to resolve given that requiring collateral in such circumstances is clearly appropriate, while any solution that involves reducing or removing the cost of failure for individual participants would introduce a problem of moral hazard and is therefore likely to come at too high a cost. Instead we would recommend waiting to see if the measures to increase liquidity also encourage a centralised clearing entity to enter, as seen in Germany and the Nordic region. This would allow collateral to be posted on net, rather than gross, positions.

- **Network charge stability:** The frequent regulatory reviews of the structure of charges have meant that there has been an increase in variability of network charges, and a lack of transparency to suppliers about the direction and timing of changes to them. Ofgem should take more account of the supplier implications of the policy changes it makes to network charges. In particular, it should seek to ensure that any resulting changes in charges are notified to suppliers sufficiently far in advance, and for charges to be kept stable for sufficiently long periods. Suppliers will then find it easier to offer the price stability that most customers expect. This will become more important if, as expected, network charges start to rise.

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\(^3\) For example, see “ScottishPower’s six commitments to boost wholesale power market liquidity”, open letter to Ofgem (10 December 2010).

\(^4\) “Liquidity in the GB power market: Update”, Ofgem (3 December 2010).
1 How competitive is the market?

In this section we provide a brief overview of the level, and type, of competition in the energy retail sector. We assess its strengths and weaknesses and see where there may be a case for further intervention.

New entry to this market has been relatively low in recent years. However, this is neither necessarily surprising, nor necessarily detrimental to customers. Price competition in this market has been strong and suppliers have competed actively for market share. There have also been a number of innovations in energy retail services.

We look at competition in the market across the following dimensions:

- customer engagement;
- evolution of market structure; and
- type of competition.

1.1 Customer engagement

Customer engagement is a clear success story of energy liberalisation in the UK. By 2008, at least 75% of customers had switched energy supplier at least once. This is equivalent to just under 20 million households.5 Further, of those who have never switched, a sizeable majority (83%) are aware that it is possible to switch.6 Ofgem concluded that:

“The level of consumer participation in GB energy supply markets is amongst the highest of any retail energy market throughout the world. The annual switching rate of 18 per cent also compares well with other retail services in the UK, such as fixed and mobile telecommunication, insurance products, mortgages and personal current accounts.”

Switching levels remain high, despite the more stable prices experienced over the last two years. The latest figures provided by Ofgem show that switching in 2009 was 17% for gas customers and 18% for electricity customers.8

While overall switching rates were high, there has been concern that certain customer groups have been switching less than others. However, the difference in switching rates across customer groups was one of the areas that Ofgem sought to address through the remedies it put in place following its investigation.

6 “Update on Probe Monitoring”, Ofgem (July 2010).
7 Ofgem (October 2008) p5.
8 “Update on Probe Monitoring”, Ofgem (July 2010) p1.
It is too early to assess whether these remedies have changed switching rates amongst different customer groups. Further, as we discuss later in this report, we have some concerns that these remedies may actually lead to an overall reduction in competition in this market.

1.2 Evolution of market structure

The number of suppliers was at its highest in the period immediately following market opening. At this time all 14 former public electricity suppliers (PESs) and British Gas were in the market and a number of new suppliers also entered. A period of exit and consolidation then followed and there are now six large suppliers, who have a combined market share of over 99% of domestic supply, and a small fringe of suppliers, who have less than 50,000 customers each. There are also a number of “affinity deals” whereby companies with established brands (such as Sainsbury and Marks and Spencer) market the energy of a supplier.

This pattern of new entry followed by exit and consolidation is not surprising: there is inevitably a process of learning what business models work in a newly liberalised market. Further, initial competition was buoyed as price controls on the incumbents were in place and were set to ensure that the supply margin was high enough to attract new entry. As we discuss later in this report, changes to the wholesale market arrangements and availability of credit have also had an impact.

Yet despite this consolidation, the number of suppliers still compares well with the rest of Europe, as illustrated in Table 1.

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9 E.ON, RWE npower, SSE, EDF Energy, British Gas and Scottish Power.
Table 1. Retail Market Position in Electricity, 2008.

<table>
<thead>
<tr>
<th>Electricity</th>
<th>Companies with market share over 5% in whole retail market</th>
<th>Market share of three largest companies in whole retail market</th>
<th>Number of nationwide suppliers</th>
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<tr>
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<td>7</td>
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</tr>
<tr>
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<td>19</td>
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<td>Great Britain</td>
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<td>59*</td>
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<tr>
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<td>100</td>
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How competitive is the market?
Despite this, the lack of new entry of any significant scale in recent years has been noted by both Ofgem and Government. It is therefore important to consider whether there are barriers to entry into this market, or whether this structure is an efficient response to industry characteristics.

One feature of this market is that the larger suppliers are, to varying degrees, vertically integrated with generation interests. Between them, the six largest suppliers have a market share of 67% of the wholesale market. However, this is not unexpected in a market with the inherent economic characteristics of the electricity supply industry. Further, although all of the six largest suppliers have group companies that have generation interests, there is significant variation both in the level of generation they hold and the business models used.

Investing in long-lived assets that have a high sunk cost because they have only one use, and have an uncertain demand associated with them, is very high risk. Vertical integration can be a sensible, and low cost, way in which this risk can be managed. It can encourage investment in generation by providing more certainty to investors. Indeed it could be argued that the level of investment required in generation to meet the dual challenge of decarbonisation and delivering security of supply over the next 10 to 15 years is more likely to be delivered within a vertically integrated structure. It can also be pro-consumer because it reduces the price volatility that they would otherwise be exposed to. Vertical integration is therefore common in energy markets around the world and it should not be seen as a failure of competition. Further, when the European Commission undertook its Sector Inquiry into the energy industry between 2005 and 2007, it did not find

### How competitive is the market?

<table>
<thead>
<tr>
<th>Country</th>
<th>30%</th>
<th>90%</th>
<th>100%</th>
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<td>97</td>
<td>17</td>
</tr>
<tr>
<td>Estonia</td>
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<td>99</td>
<td>3</td>
</tr>
<tr>
<td>Greece</td>
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<td>Latvia</td>
<td>1</td>
<td>100</td>
<td>2</td>
</tr>
<tr>
<td>Lithuania</td>
<td>1</td>
<td>100</td>
<td>2</td>
</tr>
<tr>
<td>Cyprus</td>
<td>1</td>
<td>100</td>
<td>1</td>
</tr>
<tr>
<td>Belgium</td>
<td>n/a</td>
<td>n/a</td>
<td>12</td>
</tr>
</tbody>
</table>


that the drop in liquidity in the UK (discussed in chapter 2) could be linked to the increase in vertical integration.\(^\text{11}\)

### 1.3 Type of competition

As well as considering the number of competitors and industry structure, it is also important to see what type of competition has emerged in this market.

The first thing to note is that there is clear evidence of competition. As part of its recent investigation, Ofgem concluded that the six largest suppliers “are acting competitively and we have found no evidence of cartels”.\(^\text{12}\) They have, at least to date, primarily competed on price, through a business model that has been focused on delivering a basic energy supply service at lowest cost. This reflects the preference of the majority of customers, as well as the strong political pressure to keep energy prices low. It is also consistent with the high level of customer switching that has been seen.

It is harder to assess whether the market is functioning as dynamically as it could, as, by its very nature, it is hard to judge whether further entry would have led to increased levels of efficient innovation. What is clear is that we have seen innovation across a wide range of attributes, and a lot of this has come from the incumbent suppliers. Innovations have included the following.

- **Tariff options:** There has been an increase in the range of tariffs on offer in response to customer demand, including fixed price and capped deals to allow customers different options to budget.

- **Environmental propositions:** This includes green energy offers based on providing renewable generation as well as increasingly sophisticated tariffs and/or technology propositions aimed at helping customers to be more energy efficient.

- **Bundling of services:** We have seen the bundling of energy with other utility bills, the bundling of energy services and other products (such as heating maintenance) and the linking of energy supply with a range of affinity offers (such as airmiles or other loyalty schemes).

What is also evident is that the new entry we have seen recently has often been on the back of innovative offerings (for example through retailers whose USP is to only sell renewable energy or offer all customers a smart meter).

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We are not aware of any evidence that a lack of entry has inefficiently limited innovation in this sector to date. However, innovation may become more important in future as the need for wider energy services type solutions becomes more pressing and smart metering increases the opportunities for innovative products and services to be offered. We expect a lot of this innovation will be delivered by the incumbent firms. As in any market, we also think that new entrants could have an important role to play in identifying new and better ways of delivering energy services in this changing market. There is already evidence that the number of companies entering and competing in energy services is growing in a way that will challenge the larger energy suppliers.
2 Barriers to entry

As expected in a market with the characteristics of electricity retail, there are barriers to entry and expansion, particularly for smaller suppliers. This section looks at the main barriers that have been identified. As well as understanding the cause of any barrier, it is also important to understand the inter-dependencies between them: reducing some barriers, without addressing others, may not deliver the hoped-for change.

2.1 Delivering Government policy

Government has increasingly used suppliers to deliver policy, both to meet environmental objectives and social obligations.

Environmental obligations have increased markedly over recent years. The Energy Efficiency Standards of Performance (EESoP) that were the precursor to today’s Carbon Emissions Reduction Target (CERT) were funded from a levy of £1 per year on customers’ electricity bills. The latest estimates of the cost of CERT are around £24 per fuel per year. Although managing CERT may represent the largest burden to suppliers, there are also the costs associated with managing the Community Energy Saving Programme (CESP), the Feed-in-Tariff regime (FiTs) and the Renewables Obligation Certificate (ROCs). The proposed Green Deal will place further obligations on suppliers, as would requirements associated with proposals for a CCS levy and the Renewable Heat Scheme if they are progressed.

Suppliers are also used to meet social obligations, particularly in relation to fuel poor and vulnerable customer groups. The Government has recently consulted on formalising some of the social obligations that are being put on energy suppliers. The Warm Home Discount Scheme aims to replace the current voluntary agreement and will provide vulnerable customers with direct assistance on their energy bill. The Government has estimated that suppliers would be required to spend £310m per year by 2014/15 on this scheme. Further the increasingly onerous procedures around disconnection mean that the cost of debt recovery is increasing. This can also act as a barrier as it has cash-flow

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13 Indeed, we note that some of these barriers are required to act as safeguards to consumers.
15 The Government is committed to replacing CERT and CESP when they expire at the end of 2012 with a new Energy Company Obligation (ECO).
17 “Consultation on the Warm Home Discount”, DECC (2 December 210), p. 15.
implications that can particularly affect smaller new entrants that are less well capitalised.

These schemes have different implications on competition, depending on the way they are implemented. Common features include:

- they lead to rising energy prices, which can cause adverse media attention and customer discontent;
- they can increase the costs to suppliers, with the burden falling more on some suppliers than others and no mechanism to equalise this within some of the schemes;
- they all increase the administrative burden on suppliers;
- they can impact competition for different customers, particularly if the targets are aimed at particular customer groups;
- the complexity of the schemes can be a challenge, and there is a fixed cost to dealing with this; and
- the frequent policy changes are difficult, and costly, to manage.

Suppliers below a threshold of 50,000 customers are currently exempt from some of these obligations, including CERT. However, for the 50,000th customer, the supplier would be required to fully participate. First:Utility has estimated that as a consequence its 50,000th customer would cost it £2.5m. This is therefore a barrier to expansion for these suppliers.

### 2.2 Access to wholesale energy supplies

Availability of electricity is an essential pre-requisite for any new entry to the electricity retail market, be it by small or larger players. If new entrants are unable to secure access to electricity to match their potential customers’ load profile at a competitive price, it will act as a significant barrier.

Small suppliers say they find it difficult to secure adequate access to wholesale electricity supplies. In particular, they find it hard to access contracts of a small quantity, in the right shape, for the long duration that they are seeking, at a price that allows them to compete with the large vertically integrated suppliers.

This issue has been exacerbated following the introduction of the new trading arrangements (NETA) in 2001. Suppliers face an incentive, through the cash-out mechanism, to ensure that they balance their customer demand with their

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18 We note that Government has committed to undertaking a consultation to review this threshold (see “Consultation on the Warm home Discount”, DECC (2 December 2010) p27.

19 Independent newspaper (25th September 2010).
generation contracts. As a result of the design of the cash out prices (for example, the spread between the buy and sell price), being short is something suppliers seek to avoid as it can be extremely costly.

As suppliers continually update their demand forecasts, they will necessarily wish to fine tune their contractual positions close to real time (but before Gate Closure). On the generation side, suppliers have two options to avoid finding themselves out of balance. They can either contract with others for short term generation or, if they have their own generation, they can flex this up or down. If there were a very deep and liquid market for short term power and there were no transaction / search costs, then vertical integration would provide little or no advantage. However, in the absence of a deep and liquid market for short term power, suppliers without generation capacity may face a disadvantage as achieving a balanced position may be more expensive for them.

We consider the issue of access to wholesale energy supplies in two stages: first by looking at the liquidity of the traded markets and then considering the credit terms that are imposed. For the purposes of this report, we have not been asked to review the present cash-out arrangements and consider alternatives. Clearly, however, some alternatives may diminish the importance of liquidity and credit risk as barriers. Therefore, for the rest of this section we proceed under the assumption that the present trading arrangements remain. However, we do, in section 3, recommend a thorough review of the cash-out arrangements and their impact on competition, together with an assessment of alternatives.

2.2.1 Liquidity

There has been a growing concern, voiced particularly by Ofgem, that the level of liquidity in the electricity wholesale market is the most significant barrier to entry to the electricity retail market. Ofgem’s analysis of wholesale market liquidity (from their discussion paper of June 2009 through to their recent update in December 2010) has indicated that the GB market is less liquid than some other electricity markets.

This level of liquidity shows through in aggregate measures, such as the total churn in the market seen in Figure 1.
Figure 1. Comparative aggregate churn rates

Source: Ofgem

It is also particularly noticeable in relation to the availability of shaped products into the future, with a very small proportion of total traded volumes relating to longer dated peak instruments\(^{20}\), as shown in Figure 2.

\(^{20}\) This is something that smaller suppliers have said is important to them.

Barriers to entry
Ofgem’s analysis also indicates that there is a higher proportion of peak products traded along the forward curve in the German electricity market than in GB, with a greater proportion of products being traded both one year and two years ahead of delivery.

Some metrics indicate that the situation has been improving over time. The aggregate churn in the market has, as shown in Figure 1, been increasing over time. Similarly, the proportion of traded volume for longer term peak products has been increasing as shown in Figure 3.
However, in other metrics of interest to new entrant suppliers, such as the average size of trade (the “clip size”), there has been little improvement. Minimum clip sizes for peak contracts more than one year out are, according to Ofgem, still around the 10MW level. This makes it difficult for new entrants to cover the price risk associated with what will inevitably be initially small customer bases.

The evidence gathered by Ofgem does suggest that the GB market is less liquid than it has historically been, and less liquid than some electricity markets on the continent. The key question, however, is the extent to which this level of liquidity acts as a barrier to entry.

It does not appear that the level of liquidity has acted as a barrier to entry of (well capitalised) players at the wholesale trading level. Over recent years, a number of financial players have entered the market and traded effectively at the wholesale level.

Equally, low liquidity in longer dated products does not necessarily mean that new retail entrants will be unable to secure access to electricity at a competitive price. However, it reduces the ability of new entrants without their own generation capacity to be confident of doing so, because they will find it hard to lock in a price for the future consumption of their customer base. They will

**Figure 3. Proportion of GB OTC trading by period of delivery**

Source: OTC traded volumes, Ofgem calculations

Source: Ofgem

Barriers to entry
therefore be exposed to the risk of price volatility over time and will therefore have to allocate scarce capital to cover this risk, with an associated cost.

It is therefore likely that the levels of liquidity seen in the GB market will constitute an entry barrier to non-vertically integrated new entrants, particularly those who may be capital constrained (e.g. smaller participants). However, as we discuss in Chapter 3 below, Ofgem’s latest update on liquidity\(^{21}\) shows that there are positive signs that liquidity may be increasing in the areas that are important to small suppliers.

### 2.2.2 Credit risk

Any party selling a commodity will wish to understand the creditworthiness of their counterparty to manage their risk in the event of a default. To manage this risk, purchasers may be required to post some form of collateral. Equally, the terms on which sales are made may vary according to the creditworthiness of the purchaser, with less creditworthy counterparties being charged a premium to reflect credit risk. This is a sensible and efficient response to dealing with the risk of default.\(^{22}\)

Further, to cover the potential liabilities of the market as a whole arising from a party who is unable to settle their imbalance liabilities, market participants are required to post further collateral under the Balancing & Settlement Code. The level of collateral is linked to their estimated imbalance exposure over time (i.e. a function of forecast consumption and notified net purchase contracts).

Requirements for collateral may represent a barrier to entry in two ways:

- if the amount of collateral or the price premium is above that which would be found in a highly competitive market (relevant only for bilateral contracts), it will reduce expected margins; and
- even if the level of collateral were that which could be expected in a competitive market, credit risk arrangements may make it difficult for poorly capitalised players to enter the market.

While posting collateral has a cost for any potential entrant, it is most likely to be a material barrier for smaller, less well capitalised players that do not have a credit rating.

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\(^{21}\) “Liquidity in the GB power market: Update”, Ofgem (3 December 2010).

\(^{22}\) It is energy customers that ultimately pick up the costs associated with default, so it is correct that the market is designed in a way that minimises such risks.
2.3 Low margins

One of the reasons for little entry into this market could be an expectation of low, or negative, margins. Ofgem has previously said that suppliers’ net margins on customer bills have generally been low and that they have not seen evidence that suggests energy companies have been making excess profits. It may therefore be unsurprising that there has been little entry from small scale retail-only businesses in recent years.

It is outside of the scope of this report to comment on Ofgem’s methodology for assessing retail margins. However, we note that alternative estimations have been made that show them to be lower than those that Ofgem calculated. We also believe that Ofgem’s continued publication of margins through its quarterly reports, and frequent investigations of the industry, could itself act as a barrier to entry. This is because the effect of this policy is to act almost as a de facto price control. Given that the trigger for the latest investigation is a rise in margin that has followed a long period of very low or negative margins, Ofgem is at risk of providing a strong signal that the industry will never be allowed to earn a reasonable margin.

Margins across the vertically integrated businesses in aggregate have recently been higher than in the retail-only business. However, the fact there has been no entry at this level either (by larger entrants entering at scale as a vertically integrated player) may suggest that, even though margins are higher, they are still low enough to act as a barrier. This may in part be because it is not average margins that are important. Instead it is the level of margins on the customers that the new entrants are targeting that matter most.

As one would expect in a competitive market, margins have been lowest on those customers that are most price sensitive and likely to switch supplier. It is therefore not surprising that we have not seen new entrants focussing on these customers. Instead they have focussed on niche propositions, such as those customers interested in green energy, or the opportunities provided by new technology such as smart meters. This may be another reason why larger scale entry has not occurred.

25 Despite Ofgem itself noting that this increase in margins may be temporary, as wholesale costs are expected to increase towards March 2011.
26 Also, as we noted in section 1.2 above, investing in generation assets requires the sinking of substantial long-lived capital. The current political and regulatory uncertainty around wholesale market reform is likely to have further reduced recent generation level entry.

Barriers to entry
2.4 Complexity and regulatory burden

Industry arrangements are extraordinarily complex. They also change with remarkable frequency. This is expensive for all suppliers to manage. However, because there is an element of fixed cost associated with dealing with these arrangements and processes, it falls most heavily on small suppliers.

Ofgem sought to reduce the regulatory burden on suppliers through the Supply Licence Review it completed in 2007. This was a welcome development. However, since this time the content of the licence has been growing again and extending regulatory intervention in the market. Also, the licence is only one of many other industry agreements, codes and rules that suppliers have to sign up to and comply with. In aggregate the burden is substantial.

2.5 Network charges

One area that has been increasingly raised by small suppliers as a potential barrier is the uncertainty associated with network charges. Since suppliers must offer customers stable prices, any unexpected change to their cost base will increase their risk. Despite network charges being regulated and subject to a long term price control, they have become more volatile. Much of this has been driven by regulatory policy changes, for example to the structure of charges. The lack of transparency associated with these charges has exacerbated these problems. Further, these charges are expected to increase and therefore, absent action, the materiality of this problem will rise.

2.6 Scale economies

There are a number of costs associated with entering this market, and then expanding to reach scale. These include investment in IT systems and call centres and the costs associated with building a brand and acquiring customers. There is an element of fixed cost to these activities, and therefore they can be expected to act as a barrier to smaller suppliers.
3 Options for change

In this section we set out some options for change. In doing so we take account of the following points developed in the previous sections.

- This market is functioning as we would expect, given the inherent characteristics of the market and the trading and regulatory arrangements in place.

- Price competition amongst the six largest suppliers is strong and margins have been low and, sometimes, negative. There have also been many examples of innovation in this sector.

- However, there are barriers to entry that could be keeping out smaller suppliers.

As we will see in the rest of this section, there are not many “easy wins” in terms of lowering barriers to entry. Instead many will come at a cost and have risks associated with their introduction. Clearly any policy change that comes with such costs and risks should be pursued only if there is sufficient certainty that it will deliver a more than compensatory benefit. Given our assessment of competition in this market, the main case for change would hinge on further strengthening the possibilities for innovation through new entry. This is important given the changes required to deliver a low carbon economy and the increased opportunities that the mandated smart meter roll-out may provide.

Therefore policy makers must carefully weigh up any increased cost to customers in the short term through introducing policy changes against the potential benefits from increasing dynamic efficiency in the longer term.

Our options for change are set out in the remainder of this section.

3.1 Reduce regulatory burden

Reducing the burden on suppliers to deliver Government policy is an area for potential change. This also reflects a tendency in recent years for competition to have been downgraded as a relevant consideration in favour of customer protection and sustainability. Unless this trend is reversed, it is questionable whether there will be benefits from promoting further entry. In addition, some of these changes could be introduced relatively easily, with benefits expected to outweigh the costs associated with change.

There are four broad areas where change could help.

- **Reduce complexity and rate of change:** The complexity of the schemes, and their numbers, are partly a function of the large-scale change that is
required in the industry and uncertainty about how best to deliver it. It is also driven by the number of people and organisations that want to be “seen” to be doing something. As certainty increases, it is hoped this will be reflected in a simplification of approach and a slow-down in the rate of policy change. However, Government and Ofgem could seek to better co-ordinate policies and do more to manage the adverse impact any further changes have on those that must deliver it.

- **Allow competition to flourish:** There are an increasing number of regulations that essentially limit competition between suppliers. One of the most commented-upon examples is the introduction of the non-discrimination licence provisions that Ofgem introduced in 2009, which can be expected to limit price competition between suppliers. Another example is the move to standardise small business contract terms, thus limiting the scope for suppliers to compete on non-price terms. There should be a review of the impact of these regulations. Indeed, without this reform, it is questionable whether it is worth incurring any additional costs to reduce other barriers to entry given that limits are being placed on any resulting competition.

- **Review the role of suppliers:** Using suppliers to deliver multiple environmental and social policy measures seems to have become the natural default of policy makers. It may be worth revisiting whether suppliers are best placed to deliver such policy. For example, certain requirements may be better placed with the monopoly network companies, particularly if the cost of delivering these policies continues to rise and there is a case for spreading cost recovery over time. If this is not appropriate then better recognition needs to be given to the impact on retail competition that results from these obligations.

- **Change the way Government policy is being implemented:** If suppliers are used to deliver policy, consideration should be given to making changes to the way these are administered.
  - If there is a threshold to participation in a scheme (e.g. as there is for CERT), the level of threshold could be reviewed. Obviously a higher

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27 George Yarrow, Stephen Littlechild, Sir John Vickers and Catherine Wadhams Price all wrote to Ofgem to voice concerns about the anti-competitive effects of this policy (see www.utilityweek.co.uk/news/uk/electricity/ogem-board-member-quits-quits.php).

28 A recent paper concluded that “the most likely effect of the licence condition is to reduce competition in the mainstream energy markets”, “Non-discrimination clauses in the retail energy sector”, Morten Hviid and Catherine Waddams Price, CCP Working Paper 10-18 (November 2010).

29 We note that Government has committed to undertaking a consultation to review these thresholds (see “Consultation on the Warm home Discount”, DECC (2 December 2010) p27.
threshold will encourage more entry and expansion but comes at a cost as it will both distort competition and potentially limit the opportunities for customers of these suppliers to access these schemes. When determining any threshold, consideration should be given to the fact that some schemes, notably CERT, are focussed on targeting “priority” customer groups that are likely to be under-represented in new entrants’ customers.

However, any threshold is likely to act as a barrier to expansion above the level at which it is set. If Government is seeking to provide small new entrants with an advantage in this market then a glide-path could be introduced above the threshold so that any increase in costs was phased in as customer numbers increased. Alternatively, to maintain a more level playing field, small suppliers could pay a levy equal to the average cost of the schemes incurred by obligated suppliers. This would alleviate the distortion arising from excluding small suppliers from the obligation, but ensure that they did not face higher costs in delivering the obligation due to the fixed costs associated with administering such schemes.

3.2 Liquidity

Ofgem’s latest analysis\(^{30}\) indicates that the level of liquidity in the GB market is on an upward trend. There are a number of recent changes that point to an increase in liquidity for smaller suppliers.

- The products and volumes available on exchanges continue to increase. This is the case both in relation to aggregate churn and also in relation to liquidity in markets for longer term peak products.

- There are industry-led changes being made that should further increase liquidity for smaller suppliers. For example, one company recently announced six commitments it has made to take positive steps to improve the liquidity and contestability of the GB electricity market for new entrant independent suppliers\(^ {31}\). These include trading small blocks of peak contract size and expediting and simplifying master trading agreements for smaller suppliers.

\(^{30}\) “Liquidity in the GB power market: Update”, Ofgem (3 December 2010).

\(^{31}\) “ScottishPower’s six commitments to boost wholesale power market liquidity”, open letter to Ofgem (10 December 2010).
• APX’s auctioning of Britned capacity once it comes on stream and potentially wider European market coupling could also help future liquidity.

• The anticipated launch of futures products on N2EX should also improve liquidity.

• There are also “light membership” initiatives on exchanges, which could be suitable for smaller suppliers.

• Finally, DECC’s Electricity Market Reform (EMR) project may result in broader changes to the electricity trading arrangements which have an impact on the level of liquidity in the market.\(^32\)

Ofgem has quite correctly identified the importance of giving these initiatives a chance to take hold and to ensure that any intervention is aligned with wider market developments as any intervention “is not without cost or risk”\(^33\).

We would agree. Given the likely costs and risks of unintended consequences and market distortions, it is not clear to us that it would be appropriate to decide on regulatory intervention at this time. Rather, revisiting the decision in the light of DECC’s conclusions and further evidence on liquidity trends is appropriate.

Were it determined at a later date that liquidity was still a sufficiently important barrier to entry to merit regulatory intervention, the nature of that intervention would need to be considered carefully. In particular, the most appropriate intervention may not be one which is designed to increase liquidity per se, but rather one which is targeted directly to the needs of potential new entrant retailers.

The key barrier for non-vertically integrated suppliers appears to relate to the ability to secure access to electricity beyond the immediate term matching their customers’ requirements at a competitive price. A number of interventions to address this barrier directly could be envisaged.

For example, in both the German and Nordic markets procurement of small volumes has been addressed through the development of voluntary volume aggregating arrangements. Whether voluntary or mandatory (e.g. with the aggregator funded through subsidy from other participants), this may spread the administrative and legal costs of negotiating trading relationships with multiple counterparties, and may increase the level of interest among potential trading participants.

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32 Depending on the changes proposed, there may also be an opportunity for further incremental changes to the trading arrangements to further help retail entry (e.g. reform to cash-out arrangements). Consideration of the EMR in general, and reform to the trading arrangements in particular, were out of the scope of our work on this project.


Options for change
counterparties by grouping requirements together into volumes above the minimum clip size.

Equally, some of the proposals advanced by Ofgem following their liquidity review (e.g. a mandatory auction of specifically defined products, or a market making agent in such products) could also address the barrier. However, since these arrangements would necessarily require an element of centralised design of product and process, there is a risk that they are less well targeted towards retailers’ requirements and less responsive to changes in market dynamics than an aggregation agent.

If any regulatory intervention of a mandatory nature is considered, it would be important to consider carefully the likely cost of such arrangements relative to the expected benefits of new entry.

Finally, it should be noted that if the objective of regulatory intervention is to support new entry by smaller, less well capitalised retailers (e.g. on the grounds that this type of entry is more likely, or more likely to stimulate the sort of innovation that the policy may be targeting), addressing the issue of access to forward electricity products is necessary but not sufficient. Other issues, in particular credit risk, would also need to be addressed.

### 3.3 Credit risk

The requirement for collateral can in theory be met in one of two ways: bilaterally, in which participants post collateral with each other, or through a clearing house, in which collateral is posted with a central counterparty who then assumes all credit risk.

Virtually all OTC trades in GB were cleared bilaterally rather than through a clearing house in 2007. This is in stark contrast with Germany and the Nordic region, where centralised clearing of bilateral contracts is a well established practice. Centralised clearing can have a number of advantages over bilateral clearing, particularly for smaller counterparties. Not least among these is the ability of the central counterparty to pool multilateral trading positions, and require collateral to be posted on net positions rather than a series of gross positions.

If it were the case that excessive requirements for collateral were being placed on smaller non-vertically integrated participants (relative to that which would be observed in a competitive market), then the incentive for those participants to encourage the creation of a centralised counterparty would be even greater. Since there are entities in GB who could provide clearing services (e.g. London

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34 Ofgem (2009).
Clearing House), the absence of a centralised clearing party for the OTC electricity market may be a result of a perceived lack of demand for such services. If credit risk arrangements were perceived to be an important barrier to entry (in particular for poorly capitalised players), one possible solution would be to encourage the entry of a centralised clearing entity. *In extremis*, this could be achieved through the provision of some form of subsidy to a clearing entity. Such an intervention would continue to leave the responsibility for providing collateral (at a lower level) with new entrants, and, depending on how this proposal was implemented, need not imply classes of participant being treated differently.

However, one potential reason for the perceived lack of demand may well be low levels of liquidity (although we note that centralised clearing is practiced in both the Netherlands and France, where the volume of trade to be cleared is likely to be lower than that in GB). Therefore, prior to taking such a step, we would recommend waiting to see if the developments discussed in the previous section lead both to an increase in liquidity and encourage a clearing entity to enter.

If this did not happen, further interventions could be considered, but would be likely to have unintended consequences. In particular, a problem of moral hazard could be introduced if the credit requirements for smaller players were relaxed. Reducing or removing the cost of failure for individual participants could incentivise excessive risk taking and make failures more likely. This will increase costs (as the cost of failure is borne by the rest of the market and, eventually, customers) and, if there were more frequent “disorderly exit” from the market, impact on market confidence, liquidity and investment. We believe the potential downsides of such solutions would be too high to warrant such intervention.

### 3.4 Cash-out arrangements

As discussed in section 2.2, availability of electricity is an essential pre-requisite for any new entry to the electricity retail market and the current cash-out arrangements may be acting as a barrier to entry to retailers.

For the purposes of this report, we have not been asked to review the present cash-out arrangements and consider alternatives. However, there are *a priori* reasons for expecting the current cash-out arrangements to act as a barrier to entry into the retail market, which should be tested. Ofgem is waiting to consider the conclusion of the Government’s recent Electricity Market Reform (EMR) before deciding whether to launch a review of electricity cash-out arrangements.

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In the light of the changes to the market framework that are expected from the EMR, it would seem timely to review the cash-out arrangements.

### 3.5 Increase network charge stability

The frequent regulatory reviews of the structure of charges have meant that there has been an increase in the variability of network charges and a lack of transparency to suppliers about the direction and timing of changes to them. Ofgem should take more account of the supplier implications of the policy changes it makes to network charges. When making policy changes, it should seek to ensure that any resulting changes in charges are notified to suppliers sufficiently far in advance, and for charges to be kept stable for sufficiently long periods, to enable suppliers to offer the price stability that most customers expect. This will become more important if, as expected, network charges start to rise.

### 3.6 Deliver on potential of smart meter roll-out

Smart metering is a real opportunity for retail competition. For example, it should enable more innovative tariffs and wider energy services propositions, as well as making customer switching between retailers a faster and easier process. Therefore, getting the smart meter roll-out right should both reduce the barriers to entry and increase the level of innovative entry that is possible in this market.

To deliver these benefits a number of actions need to be taken.

- **Minimise the risk that costs increase to small suppliers during roll-out:** Suppliers are responsible for installing smart meters for their customers. If there are fixed costs with this activity then this could disadvantage small suppliers. Further, some of the requirements that may be placed on suppliers as part of the roll-out may be particularly onerous for small suppliers (for example if there is an element of geographical co-ordination to the roll-out). In the event that such policies were pursued, it may therefore be appropriate to consider derogations for suppliers below a certain threshold from certain requirements.

- **Ensure it delivers supplier benefits:** A number of the benefits of smart meters will be particularly advantageous to small suppliers. Improving industry processes, easier switching between credit and prepayment terms and easier switching of supplier should all help small supplier entry providing they are achieved.

- **Do not create new barriers:** The platform that smart metering will provide should increase the opportunities for innovation in this sector. This may be within a narrow energy retailer role where, for example, it is important that
both settlement and data privacy solutions\footnote{For example, constraints on the frequency of accessing time of use data could limit the tariffs that suppliers could offer.} do not act as a barrier to introduction of innovative tariffs. It may also be within a wider role, as retailers seek to expand their business model. For those cases, care needs to be taken to make sure that there is nothing in the industry arrangements (in particular associated with protocols or the central communications infrastructure) which will make it harder for new entrants to offer wider energy services such as integrating retail with additional home automation services.
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