

Which?

RESEARCH SUMMARY JUNE 2018

Cornwall Insight report: Innovation in the energy market – impact of the default tariff price cap

A Which? summary



Which? is concerned that the energy market is not delivering good outcomes for the majority of consumers. We agree with the Competition and Markets Authority (CMA) that weak competition and consumer engagement mean that consumers who fail to engage in the market face excessively high prices.

Which? commissioned a report from market-leading consultancy Cornwall Insight to provide additional evidence for our response to Ofgem's June 2018 consultation on the energy price cap. The report outlines the current innovation landscape in the sector, examines the possible impacts of the cap on innovation (e.g. technological, commercial), and includes case studies on the impacts of price caps in other sectors and jurisdictions on innovation. Cornwall Insight undertook interviews with a range of (industry and non-industry) stakeholders to inform their research.

What is innovation?

The report defines innovation as fitting into two distinct categories:

- 1. The evolution of existing products, which would typically take place within the current regulatory framework or would be unlikely to require extensive regulatory change.**

Evolution is more likely to be undertaken by incumbent suppliers and providers. Examples of evolutions include smart home devices and the development of comparison websites into easy to use, app-based services.

- 2. A revolution of new products and business models through market disruptions, which will typically require the regulatory framework to adapt and evolve more quickly.**

Revolution is more likely to be undertaken by new entrants to the market, such as technology providers and transport companies. Examples include peer-to-peer trading through blockchain, localised energy generation and cooperative purchasing.

How will the price cap impact innovation?

Suppliers will face a strategic choice in their response to the price cap – a choice between short-term cost-reductions, with a focus on maintaining profit margins; and long-term diversification, with a focus on customer retention. The latter is likely to involve a greater emphasis on innovation, both for new product offerings and competing beyond price to find new points of differentiation between suppliers. How suppliers make this strategic choice is likely to depend on a range of factors, including their size and the proportion of their customers based on default tariffs.

If the cap is set at a relatively low level, the report suggests supplier responses may include:

- Moving customers off default tariffs onto uncapped tariffs, which may be more expensive than the capped default tariffs;
- Accelerating the rate at which they pursue bundling offers with other suppliers and with companies outside the energy sector, to allow suppliers

to offer new products and services – this will mean that competition is not just based on price, and suppliers may be able to recover lost income by offering new products;

- While bundling can offer advantages for many consumers, it can also increase complexity and make it harder to compare suppliers if it's not clear what the cost of electricity is, or if customers are in more complex contractual agreements.

- Increasing the price of uncapped tariffs;
- Reducing costs through other means, potentially resulting in a reduction in customer service standards; and/or
- Consumer benefits from innovation may reduce if a supplier's ability to raise capital to fund new projects is diminished by lower rates of return.

Conversely, if the cap is set at a relatively high level, supplier responses may be more limited as it may allow for business as usual to continue. However, there is a risk that suppliers will then increase the cost of their default tariffs to the maximum cap level to maximise profit. This, combined with the potential decrease in consumer engagement, if people feel a false sense of security under the cap, would result in many customers paying higher prices than necessary.

The report expects the underlying trend of innovation to continue under a price cap, though the extent to which it is accelerated or slowed by the cap will depend on supplier responses and their ability to adapt. Cornwall Insight note that the supplier landscape is already changing in response to the cap, with larger suppliers continuing to lose customers, many are changing their policy on default tariffs, while mergers and consolidation within the supply community are set to continue under the cap.

Lessons learned from other jurisdictions and sectors

The report includes case studies of innovation in energy sectors in other countries with price caps (e.g. Italy, USA), as well as other utility sectors with price controls (water, telecoms). Of particular relevance to the default tariff price cap are case studies on Great Britain's prepayment meter (PPM) cap and on Italy's energy market.

The PPM cap was introduced in Great Britain in April 2017, as recommended by the Competition and Markets Authority. Cornwall Insight found that under the PPM cap, innovation in the market increased, as suppliers looked to compete on factors other than price.

The PPM cap has seen large and medium suppliers cluster their prices at the top of the cap, while smaller suppliers tend to be £40-60 below the cap. Due to a decrease in the differences between tariff costs under the cap, suppliers found other ways to differentiate their service to try and retain and entice customers. For example, many smaller suppliers increased the availability of online account management and hastened the rollout of smart meters for PPM customers. This example shows one possible way for suppliers

to react – to increase innovation which benefits consumers – but does not necessarily mean that the default tariff cap will have the same impact.

In Italy, by 2017 over 35 million customers had a smart meter installed. While in GB, the Government claims that smart meters will lead to increased consumer engagement and more switching, this has not been seen in the Italian market. Indeed, the incumbent Italian energy supplier retains an 86 percent market share.

While Italy doesn't have the same type of price cap as that being proposed for default energy tariffs in GB, prices are regulated. One of the reasons the GB energy price cap has been prescribed initially to 2020 is to coincide with the end of the smart meter rollout. However, the Italian case study demonstrates that smart meters alone will not result in more switching; it is important for other measures to continue to incentivise increased customer engagement.

What does the report recommend?

After analysing the current innovation landscape, the other policy reforms already in train, the lessons learned from other sectors and countries, and interviewing industry and non-industry stakeholders, the report identifies the following core challenges for Ofgem:

- Communicate the transitory nature of the price cap and encourage increased consumer engagement, alongside the smart meter rollout;
- Ensure a proactive regulatory regime that encourages both evolution of products, and revolution through market disruptors;
- Continue to provide disruptors a forum within which to test their ideas, such as the regulatory sandbox which Ofgem introduced in 2017;
- Minimise regulatory uncertainty from the cap by communicating effectively to both suppliers and consumers – particularly regarding the criteria for the cap's removal prior to 2023 and how updates to the cap will be made over time; and
- Provide clear insight on how various policy changes currently in progress (such as the smart meter rollout and efforts to introduce next-day switching) will work, and how these changes will interact with one another and the price cap.

Which?'s response to the price cap

The report supports Which?'s response to Ofgem's June 2018 consultation on the energy price cap, which outlines the following key issues:

- 1. We are concerned at the lack of evidence Ofgem has provided regarding what consumers think about the price cap and how it will affect them.** Ofgem must monitor consumer behaviour in response to the price cap to fully understand its implications and to determine the impact of the cap on consumer detriment.
- 2. We are also concerned that the consultation does not cover how the cap will be communicated to consumers.** Given the potential for the price cap to have an adverse effect on consumer engagement (if it is seen as a protection measure) how it is communicated – by Ofgem, suppliers and others – will be critical to how consumers respond to it and therefore its overall effect.
- 3. The energy market is evolving in ways that could not have been thought about even ten years ago.** Ofgem should retain its focus on encouraging new business models into the energy market. Regulation must not only keep pace, but also encourage new innovations and technological change.

Further information on Which?'s position on the price cap can be found in our response to Ofgem's consultation, available on our website from 25 June 2018.

About Which?

Which? is the largest consumer organisation in the UK with over one million members and supporters. We operate as an independent, a-political, social enterprise working for all consumers and funded solely by our commercial ventures. We receive no government money, public donations, or other fundraising income. Which?'s mission is to make individuals as powerful as the organisations they have to deal with in their daily lives, by empowering them to make informed decisions and by campaigning to make people's lives fairer, simpler and safer.

About Cornwall Insight

Getting to grips with the intricacies embedded in energy and water markets can be a daunting task. There is a wealth of information online to help you keep up-to-date with the latest developments, but finding what you are looking for and understanding the impact for your business can be tough. That's where Cornwall Insight comes in, providing independent and objective expertise.



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