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Business and Enterprise Committee

Energy prices, fuel poverty and Ofgem: Government Response to the Committee's Eleventh Report of Session 2007–08

Seventh Special Report of Session 2007–08

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Seventh Special Report

The Business and Enterprise Committee published its Eleventh Report of Session 2007–08 on 28 July 2008. The Government's Response was received on 2 October 2008 and is appended to this Report. On 6 October 2008 Ofgem published the initial findings of its investigation of the UK's energy supply markets, which ran concurrently with our own inquiry. Its conclusions also respond in part to the Committee's own recommendations and conclusions.[1]

Government response

Introduction

The Government welcomes the **Business and Enterprise Select Committee's Eleventh report: Energy prices, fuel poverty and Ofgem.** The Committee's Report constitutes a constructive assessment of the complex factors at work in UK and wider international energy markets.

The Government maintains and, as necessary, develops the overarching regulatory framework for UK energy markets. Within this framework Ofgem is responsible for monitoring and promoting competition in the GB energy markets, and it is primarily for Ofgem to take the initiative in any market investigation under the Enterprise Act 2002.

While many of the Committee's recommendations are addressed primarily to Ofgem, given the Government's ultimate responsibility for the health of the overall framework, we have in places added additional comment from the Government's point of view.

Like the Committee, the Government has welcomed Ofgem's announcement of an inquiry into the energy supply markets for households and small businesses. We look forward to seeing the initial results when these are published in the near future.[2]

Responses

The Committee's specific conclusions and recommendations are reproduced in bold below. Each is followed by the Government response. We note where recommendations are in the first instance for Ofgem.

The UK gas market

6. We are troubled by the apparent discrepancy between the figures cited by our various witnesses on the extent to which gas is delivered to the UK via off-market contracts, as opposed to the visible market. The absence of consensus on such a basic characteristic of the market makes it difficult to reach secure public policy conclusions about desirable interventions.

[1] Ofgem, *Energy Supply Probe—Initial Findings Report*, 6 October 2008

[2] As noted above, Ofgem has since published its initial findings

The Government agrees the importance of reaching policy decisions based on evidence. It may be helpful to note some factors which can complicate analysis of gas markets and contracts. Commercial confidentiality can be an obstacle to obtaining data on trading and contract activity. A lack of shared terminology, and the complexity of many gas contracts (which, in addition to specifying the term, price and volume conditions may include several other parameters) can also make accurate summary difficult. It is possible that these factors could contribute to different market participants and commentators providing information that seems contradictory.

For example, it may not be possible to meaningfully define what percentage of the UK gas is traded on exchanges, on the over-the-counter market, or via bilateral contracts. This is because, as the Committee has noted, much more than 100% of the gas ultimately delivered to customers is traded in the years and months that precede the delivery date. Moreover, individual companies' strategies may well diverge quite substantially from the "average".

It is not the Government's understanding that particular forms of gas sales and trading are more advantageous for public policy purposes than others. Rather, we believe that producers, traders and customers need a number of ways in which they can transact in the gas market, such that the instruments and markets available meet their commercial needs.

What is critical is that we can be confident that the markets that do exist and represent large proportions of gas supplied in the UK, and act as price benchmarks, are working effectively. Clearly, transparent and well-understood market information is a key element of well-functioning markets, and we value the efforts that the industry, National Grid and Ofgem have made to increase transparency of the gas market. For example, National Grid's website now provides near-real-time flow information on gas being landed in the UK, disaggregated by sub-terminal. It also provides considerable forward-looking information which should provide a basis on which gas market participants can develop informed views about the future supply/demand balance, and hence prices.

7. While the UK has one of the most liquid spot markets for gas in the world, industrial consumers and Energywatch have significant concerns about the lack of liquidity in the forward gas market—an issue our predecessor Committee raised in 2005. Given the apparent impact on the prices major users pay in comparison to their competitors on the Continent, we recommend that Ofgem investigates urgently why gas producers seem unwilling to trade in the forward market. This investigation should include the wider market effects of both the lack of price transparency for forward contracts and the risk premiums attached to them. If Ofgem is unable to reach firm conclusions or suggest appropriate remedies, it should consider a referral of this aspect of the wholesale gas market to the Competition Commission.

It is indeed for Ofgem to decide whether to initiate an investigation of this kind.

In as much as higher liquidity helps the operation of the market, the Government shares the Committee's interest in liquidity in the gas forward markets. DTI commissioned a comprehensive report (published in March 2005 and available at http://www.berr.gov.uk/files/file33153.pdf) from consultants Global Insight to investigate aspects of the forward market. This report made several conclusions about the market at that time. It reported that there were then natural reasons for many producers not to want to sell forward, and that these reasons were not anti-competitive. It further concluded that the "risk premia" that were being demanded in the forward market were not disproportionate compared to the risks sellers to the forward market were facing. The report also concluded that the forward market at that time was not subject to abuse of market power and was functionally liquid, although it was not as liquid or mature as other global commodity markets, which did result in some limitations.

Increasing gas dependency

8. The implication of the UK's growing gas import dependency is that it must increasingly compete in European and global markets. This means the UK gas price is influenced by changes in supply and demand in other countries. Also, where market distortions exist in other countries, such as the oil-gas price link in Europe, which we discuss later, this too will affect the UK gas price. The existence of import capacity does not necessarily guarantee the flow of gas to the UK. Rather, this is determined by market attractiveness and willingness to pay.

We share the Committee's analysis: import infrastructure is a necessary requirement for ensuring the UK's security of gas supply, but it cannot deliver this key objective on its own. The price UK suppliers pay for wholesale gas is influenced by demand and supply in other countries. However there are measures we can take to influence producers' market decisions.

We are taking steps to improve the attractiveness of the UK as a destination for producers. We are facilitating increased storage and import infrastructure investment. We continue strongly to support reform of the EU energy market to ensure that prices across Europe are set in competitive markets and that everyone has access to gas at a price determined by demand and supply fundamentals. Beyond the EU we are working to achieve further development of the international gas market, including LNG, and to ensure the attractiveness of the UK market to importers.

Closer to home, we are strongly encouraging economic recovery of oil and gas from UKCS.

Wholesale gas market concentration

9. Whilst the overall level of gas market concentration is relatively low, current figures provide only a snapshot of a rapidly evolving market. Market concentration in the supply sources on which the UK will become more dependent in the next few years are much higher than that for the UK Continental Shelf. Ofgem must monitor this situation closely, particularly if the marginal source of supply to meet UK demand increasingly comes from these highly concentrated markets.

We agree that Ofgem will continue to have a crucial role in overseeing sector competition.

Some major supplier countries have national monopolies. This makes it all the more important to develop and maintain a diversity of supply sources. Developing import infrastructure increases our capacity to take advantage of such diversity in sources and routes, giving us the opportunity to import from a wide range of countries including from the Middle East, North Africa, Trinidad and Tobago, as well as sources closer to home such as Norway and the Netherlands.

10. Ofgem states that in examining the competitiveness of the gas supply market it is worth noting that "at certain price levels a demand side response occurs" and that this can "act as an additional brake on potential market power". The regulator should remember that this brake has a very real social and economic cost. We cannot form public policy in a world of energy shortages and sharply rising prices on the complacent assumption of a "demand side response". The gas price spikes of winter 2005/06 were cited as a key factor by the industrial energy user groups in the loss of around 100,000 manufacturing jobs in the months that followed.

The Government shares the Committee's recognition of the very serious potential social and economic impacts of consumers being compelled to make critical reductions in their energy use for reasons of cost.

However, it should be noted that not all demand side responses to changes in prices and available capacity have lasting negative impacts. Planned demand side management (DSM) can have a beneficial role to play in managing impacts within energy systems. For example, DSM can involve reducing demand from some industrial users at peak periods, and raising it at off-peak times, leaving overall consumption by those users unchanged. Managing periods and patterns of use to smooth out peaks and troughs in demand can reduce the maximum capacity required in a system at any one time, and so can reduce the investment required and ultimately the costs to consumers.

DSM can also manage temporary spikes in price and/or restrictions in supply. In this context it is useful to note that the sector of the gas market that currently provides the greatest demand response is the electricity generating sector, and it is able to do so with less disruptive impacts than some other sectors. Companies in this sector can swap between fuels/generators and use distillate back-up at CCGTs when gas prices rise without there necessarily being a reduction in output.

LNG import capacity

11. The Isle of Grain LNG import terminal has seen little use this year. It is possible the regulatory framework for the use of the facility is part of the reason why LNG cargoes are not coming to the UK. Ofgem should investigate the situation with a view to making any necessary changes. Moreover, if international price competition can so easily drive cargoes elsewhere there must be doubt about the extent to which new capacity, such as Milford Haven, will provide the anticipated benefits in terms of security of supply for winter 2008/09. Ofgem and the Department should explore the possibility of such diversion of supplies to inform other aspects of energy policy, specifically in relation to gas storage.

As above, we fully agree that the development of import facilities does not guarantee their use. The Government takes into account the market conditions of LNG trading and import when considering other energy policy and gas market issues.

We note that Ofgem's evidence to the Committee summarises results of their inquiries in the last year into the operation of arrangements at Isle of Grain. It will continue to be important that the regulatory framework meets the needs of the market.

The UK has diverse sources of gas supply—UKCS, by pipeline directly from Norway; imports from the Continent through the Interconnector and BBL pipeline; and imports of LNG by tanker (to the Isle of Grain, Teesside, in the future Milford Haven and potentially elsewhere). The nature of the LNG market, as highlighted by the Committee's report, reinforces the need for a diversity of import infrastructure. Different LNG facilities can operate to different usage and business models. Industry is investing in a range of infrastructure.

There are currently a limited number of LNG tanker cargoes which are free to sail to any destination in response to price signals, as many are locked into long-term contracts. However the number of flexible cargoes is expected to increase over time.

Gas storage

12. The Government has not responded quickly enough to the UK's increasing, and entirely predictable, gas import dependency by encouraging investment in storage. This is an issue our predecessor Committee raised in its 2002 and 2005 Reports on security of supply and fuel prices. Significant additional storage, beyond that currently planned, is needed to reduce volatility in the wholesale gas price, which is otherwise likely to increase as the UK becomes increasingly dependent on gas imports. It is now an issue of national importance and should be a high priority in domestic energy policy.

We agree that increasing gas storage is vital to put the UK gas market in a stronger position to deal with present and future risks to different international supply sources.

Existing storage capacity is over 4bcm, 0.8bcm is under construction and a further 13.8bcm is proposed which if it goes ahead could come on stream by 2015/16. This does not include new and expanded LNG storage at LNG import facilities.

The Government is responsible for maintaining and where appropriate developing a framework which will draw in the necessary investment. Planning is currently a real barrier to confident and timely decisions on the very large investments we need in storage and other energy infrastructure, and that is why it is so important to achieve the improvements to the planning system set out in the Planning and Energy Bills, now before Parliament.

Offshore, several proposals for significant new gas storage facilities are under consideration and the introduction of a new offshore licensing scheme under the Energy Bill will ensure that there is a fit for purpose regulatory framework to determine applications which come forth for sub-sea gas storage and offshore unloading of gas imports.

European-UK gas price link

13. In recent years, the European gas price has set the floor for the UK price during the summer, when the UK has been a net exporter and its gas has generally gone into

boosting European winter storage levels. In winter, prices have risen markedly above European levels in order to draw gas to the UK. We are concerned that European gas suppliers are not responding to price signals more quickly during the winter months by selling into the UK. We strongly support the efforts of the European Commission both in its attempts to increase the transparency of, and to liberalise certain contractual and legal aspects of the European gas markets. Its task is particularly challenging, given countries have increasing concerns over energy security. The Government must also continue to exert strong pressure in this regard, as a political solution to this issue would do more to improve UK market conditions than any other domestic or international initiative. We consider these objectives should be a high priority for the Government in negotiations on EU policy generally, not simply within energy policy.

We fully agree with the emphasis here. A properly functioning EU energy market is vital to the UK. We have strongly supported and encouraged the Commission in improving the market, and we fought hard in negotiations with other Member States to prevent the watering down of the Commission's package of proposals of September 2007 for further internal energy market legislation. Political agreement was reached on this package in June 2008 and, subject to the agreement of the European Parliament, we expect it to come into force early in 2009.

This new legislation should significantly improve the operation of the internal energy market, with more effective regulation, increased transparency and more effective unbundling of vertically integrated companies to ensure non-discriminatory third party access to networks.

Oil-gas price link

14. The contractual link between oil and gas prices on the Continent distorts the wholesale gas market and therefore the environment in which investment and consumption decisions are made throughout the EU. In the absence of liberalisation in the short to medium term, it seems unlikely that market liquidity will increase sufficiently on European trading hubs to provide an alternative means of indexing long-term gas contracts. The oil price will therefore continue to have a significant influence on UK gas prices. It is likely that European gas prices will continue to rise in lagged response to the current increases in oil prices, and thus will feed through to the UK market.

We agree that oil prices are influencing UK gas prices, alongside the UK's own gas demand and supply fundamentals. Continuing pressure to liberalise continental Europe and facilitating the development of the international gas market, including LNG, will put increasing pressure on the oil price linked contracts and are expected to lead to a reduction in their dominance over time.

The Government will continue to study the influence of oil prices on gas prices, and will push for action if this leads to anti-competitive results.

15.Trading on London markets plays an important role in setting the global price of oil. We fully acknowledge the important role futures markets play in helping purchasers of

commodities to hedge against future price movements and so assist in planning their businesses. We also note the Treasury Committee's current interest in this subject. We consider, however, that the Financial Services Authority would be well advised to investigate the extent to which speculators within its jurisdiction are currently driving up global oil prices, and to take action if appropriate.

The Government published its latest assessment of the relationship between speculation on futures markets and commodity prices, including energy prices, in *Global Commodities: a long-term vision for stable, secure and sustainable global markets* on 12 June 2008.

The available evidence suggests that speculation (i.e. the activity of financial investors), has not been a determining factor behind the recent energy price increases. The main driver of the recent energy price inflation reflects developments in the underlying physical markets and views about future prospects for supply. Although there is insufficient evidence to conclusively rule out any impact from speculation, it is likely to be only small and transitory relative to fundamental trends in demand and supply for the physical commodities.

The Government continues to assess the available evidence regarding the relationship between speculation and commodity prices. The FSA's mandate in its financial oil markets regulation is to ensure that markets are fair and orderly, that investors are afforded suitable protections, and that market abuse by market participants is prevented as far as possible and, where it occurs, is detected and dealt with appropriately. The Government will ensure that FSA is made aware of the Committee's views.

The Government looks forward to the outcome of the Treasury Select Committee's enquiry into regulation of oil markets.

Gas contracting

16. Clearly something is wrong with the GB wholesale gas market if INEOS ChlorVinyls, one of the UK's biggest industrial energy consumers, would rather ship gas from abroad under a European contract, than engage directly with the domestic market. Not only should Ofgem investigate why companies are behaving in this way, in conjunction with the European Commission it should also investigate the legality of gas suppliers offering widely different contract terms in different jurisdictions within the European Union. We cannot believe such behaviour is compatible with the Single Market.

If there is any incidence of restrictions on fair access by UK companies to EU energy markets, or unfair subsidisation of energy costs in other EU member states, the Government will want to be informed, and will not hesitate to take action or otherwise to support the full enforcement of competition and Single Market rules by Ofgem and/or the European Commission.

The wholesale gas market and Ofgem

17. One of our major concerns is that Ofgem's investigation is not giving more explicit attention to the wholesale gas market. In 2004/05 Ofgem conducted an inquiry into the

upstream sector in response to gas price spikes that winter, but the recent price spikes have been sharper still. The focus of Ofgem's investigation this time is on the supply to households and small businesses. As part of this it will examine the relationship between retail and wholesale energy prices. However, it also needs to look again at whether the wholesale markets themselves are functioning satisfactorily.

The scope of the investigation is for Ofgem. We fully agree the crucial importance of maintaining effective competition in wholesale and retail markets.

Wholesale electricity: rising environmental costs

18. It is clear that the 'Big 6' firms and the independent generators have, to varying degrees, benefited financially from the free allocation of permits in Phase 2 of the EU Emissions Trading Scheme. However, the magnitude of this windfall is not clear. Furthermore, at least some of the value may be passed on to consumers through lower prices, via cross-subsidy from their generating arms, while some may support much needed investment in new capacity. We are disappointed by the superficiality of Ofgem's current analysis. We recommend that the Government now conducts and publishes a rigorous analysis, estimating the value of any windfall profits which companies have gained, and the use to which they have been put, or are planned to be put. It is only on this basis that the Government can then decide if there is a case for reallocating some of this windfall—an issue we return to in Chapter 5.

EU law requires the UK to allocate free of charge 90% of carbon allowances during the 2008-2013 trading period. At the current allowance price, and at the current pound to euro exchange rate, the free allocation to UK electricity generators is potentially worth around £2 billion per year. The exact benefit depends on many factors including the extent to which companies have included the value of the allowances in the price of electricity to end users. It is possible, as the Committee says, that part of any benefit may have been used to mitigate price increases for retail customers of the downstream supply businesses. The Government has announced that from 2013, it wants to auction 100% of carbon allowances to large electricity producers.

Wholesale electricity market concentration

19. At present, Britain has a diverse electricity generation portfolio, owned by a number of different companies. However, we are concerned that this may be undermined by market consolidation, such as a takeover of British Energy or Scottish Power. Ofgem and the Competition Commission should ensure that, were this to happen, measures are put in place to protect current information flows to the market, and to ensure no single generator has excessive market power. We acknowledge the urgent need to secure investment in new generating capacity, but that investment must not come at the price of a less competitive or transparent market in the long term.

Britain does have a diverse electricity generation portfolio. BERR's "UK Energy Sector Indicators" [3] listed 30 Major Power Producers in the UK at the end of 2006. The aggregate

[3] For further details on the number of MPPS, market shares and estimated HHI index see http://www.berr.gov.uk/files/file39511.pdf

share in generation of the largest generating companies was around 45% (updated statistics for 2007 will be published in autumn 2008).

We recognise the need to secure investment in new electricity generation capacity. As set out in the 2007 Energy White Paper it is estimated we would need 20-25 GW of new generation capacity by 2020 for roughly the same margins of capacity to be available as today. However, if we are at the same time to meet our share of the EU target for renewable energy this would increase to around 40 GW. The intermittency of renewables means that 1 GW of wind capacity cannot replace 1 GW of closing coal-fired capacity: we would need either 5–6 GW of well-dispersed wind capacity, or 1 GW of wind and a similar level of flexible conventional capacity, or other combinations of renewable and conventional plant to deliver the same level of security of supply. This represents a major investment challenge for the electricity generating industry as a whole, but we see no reason why this should compromise competition and transparency.

Promoting competition in UK and global energy markets is a key objective for the Government, as it is for Ofgem within GB gas and electricity markets. In particular, it is part of the independent regulator's role to monitor the gas and electricity sectors to ensure that the levels of competition are maintained, while at the same time there is adequate investment in energy infrastructure for the future.

We strongly agree with the Committee's emphasis on retaining a competitive market. Mergers or acquisitions in the market will be examined by the independent competition authorities (drawing in part on advice from Ofgem). Whether this assessment is carried out in the UK (by the OFT and Competition Commission) or by the European Commission would depend on the turnover and geographical coverage of the companies involved.

New generating capacity

20. The need for investment in new generating capacity—and associated transmission infrastructure—in the coming years is huge. This investment will only be delivered by profitable companies which see a commercial opportunity, whether they are existing players or new entrants. While the market seems to be providing price signals for the vertically integrated firms to invest in new large-scale conventional capacity, there is a question mark over whether new companies face disproportionate barriers to entry.

As we note elsewhere, the Government recognises the need to ensure that investors can have the confidence to make these major investment decisions. The Government is working closely with Ofgem and industry to address barriers to entry including planning reform, grid access, financial support and supply chain constraints. On infrastructure delivery we are putting in place a regime for offshore wind connections that will allow new players to tender to build and own new transmission assets.

There is evidence of new entry into the generation market. Over 50 GW of conventional and non-conventional electricity generation projects have agreed transmission access dates with National Grid and these projects are at various stages in the planning and development process, up to and including construction. Those projects currently under development are being taken forward by non-vertically integrated companies as well as by the "Big 6", although we note that there are joint ventures of various forms in the market, so the distinction between new entrant and established company is not always absolute.

Current examples of construction being undertaken by companies outside the "Big 6" include Severn Power (owned by Welsh Power) which is constructing a CCGT replacement for their existing coal-fired Uskmouth power station, and ConocoPhillips (a 450MW extension to their Immingham CHP plant).

We are seeing new entrants into the offshore wind market, for example Statoil, Dong Energy and Vattenfall. Due to the scale of investment required and risk, larger companies and joint ventures are expected to predominate in offshore projects in the near future, although further new entrants are expected following the current competition for new offshore development rights (Round 3). In onshore wind, although the Big Six have significant presence in the market, a larger number of players are involved, with many independent or community owned projects in the UK, for example, Renewable Energy Systems (RES), Wind Prospect, and Amec.

Vertical integration

21. While the 'Big 6' claim to be losing money in domestic supply, there is evidence that they are earning increased profits from their wholesale operations. We acknowledge that some of these profits may be earmarked for investment in new capacity rather than for distribution to shareholders, but we recommend that Ofgem conducts further work to understand where profits are being made within the energy supply chain. As part of this, we also recommend that Ofgem investigates whether it can require more detailed financial disclosure from the vertically integrated companies on the performance of their wholesale and retail operations, where they do not already provide this. Such information should not deter new investment, but would inform potential new entrants to the sector—both generators and suppliers.

The Secretary of State for Business has, in a recent letter to Ofgem, requested the regulator's view on whether vertically integrated energy utilities should be obliged to report separately on profits from their generation and supply arms, in order to increase transparency, including in relation to profitability.

Wholesale electricity market liquidity

22. The wholesale electricity market suffers from a severe lack of liquidity, which contributes to price volatility and poor price transparency. This, in turn, dulls market signals for potential investors in new capacity, outside of the 'Big 6'. It also reduces the ability of new energy retailers to compete in the market. As Ofgem has already identified the issue as a serious problem, and in the absence of tangible progress on the Market Design Project, its market probe should propose a solution. As a starting point, and in addition to any increase in transparency that can be achieved as a result of our earlier recommendation, the regulator should conduct a detailed analysis of the risks and benefits of requiring the 'Big 6' firms to trade a proportion of their electricity openly in the forward market. We acknowledge that the regulator must take account of the need to balance the effects that greater regulatory risk might have on the investment

decisions of incumbent companies. In principle, however, creating a better functioning wholesale market should facilitate new entry both in supply and generation.

We agree that liquidity in the traded market for wholesale electricity, as in the traded market for gas, is important in order to send price signals to market participants.

The latest FSA annual report on trading activity in the wholesale energy markets in the UK states that trading in the wholesale electricity markets saw strong growth in the last reporting year, after a fall in the previous year (FSA will report on trading activity on the year to 31 July 2008 in November).

According to an independent comparison of European energy markets by a major energy price reporting agency (Argus Media, June 2008) the UK wholesale market is liquid in comparison with other markets,[4] ranking second only to Germany among those assessed. This measure of liquidity considered wholesale markets both in terms of volumes (GWh) traded and number of deals per day between October 2001 and June 2008. This is not to say that greater liquidity in the UK power market would not be desirable, particularly to meet the requirements of large industrial users.

At present the UK has limited interconnection with other European electricity markets (as opposed to Germany for example) which limits the interest in the UK market from international traders. Current plans by industry participants to build further interconnections between the UK and other markets may change this over time.

Changes in supplier costs

23. Higher wholesale electricity and gas prices have been the largest contributor to increasing household energy bills, though the impact of environmental and network costs should not be underestimated. While the 'Big 6' claim to be losing money in their domestic supply businesses, as noted earlier, there is evidence that they are making much greater margins on electricity generation. We note that while the 'Big 6' have cited rising wholesale prices as the reason for collectively increasing prices in 2008, it required a 'naming and shaming' by Ofgem for two companies to reduce their retail prices in early 2007, when wholesale prices were falling. Whatever the result of their current investigation, Ofgem must make it clear it will use such an approach in the future if circumstances demand similar action.

Wholesale costs are a very substantial element of retail energy suppliers' costs, and the most volatile one in terms of price. Suppliers tend to smooth out the volatility in their costs by making retail price adjustments infrequently, and setting retail prices according to their purchasing strategies and expectations. Therefore wholesale price changes in either direction do not flow through immediately or directly to retail prices.

Previous experience suggests that competition in the UK supply markets has pushed retail prices down again after falls in wholesale prices more than in some less competitive EU national supply markets, for comparison (for example in 2007). However it is essential that the markets continue to work for consumers, and we expect that Ofgem will continue to

[4] Markets compared: UK, Germany, Czech Republic, France, Netherlands, Spain, Belgium and Poland.

act on any evidence of anti-competitive behaviour, and to promote effective competition in this regard.

Retail market concentration

24. Despite the fact that both gas and electricity supply are now dominated by just six firms, the level of concentration in both markets has fallen as the firms have competed with one another. Nevertheless, the gas and electricity markets are likely to remain highly concentrated so long as there are only six major players. The regulators should oppose any further consolidation within the 'Big 6' which would diminish retail competition, at least until one or more of the smaller suppliers has established a significant presence in the domestic market.

The retail market in the UK remains competitive, ranked as the most competitive in Europe by independent consultants Oxera ("Energy Markets Competition in EU and G7", 2006).

While, together, the six major energy companies account for the majority of retail gas and electricity markets, whether further consolidation can be permitted is a matter for the independent competition authorities. As noted above, whether this assessment is carried out in the UK (by the OFT and Competition Commission) or by the European Commission would depend on the turnover and geographical coverage of the companies involved.

Direct selling

25. Whilst direct sales currently provide the most effective means of persuading hard-to-reach consumers to switch supplier, they must be conducted with the utmost propriety. We welcome Ofgem's investigation into Npower's selling practices, and we will be looking at the regulator's conclusions and recommendations with particular care. Any further significant breach of best practice by any supplier would inevitably lead to calls for this sales technique to be abandoned. The industry must consider itself on notice.

The Government shares the Committee's view as to the need for the very highest standards of practice in direct selling. It is open to Ofgem, in the light of current inquiries and thereafter, to consider whether any further requirements should be placed on suppliers in respect of direct sales.

Switching

26. By international standards and in comparison with other sectors, there is a high level of switching in the energy supply sector. However, around half of customers are still with their original supplier for at least one fuel, and 20% have not switched either fuel source, despite the fact that incumbent suppliers consistently fail to provide the best available offer in their home areas. Moreover, most people who do switch fail to change to the cheapest supplier, and a significant number actually move onto a more expensive tariff. Ofgem is considering these issues as part of its probe. We believe its recommendations should include new ways to engage consumers that have not

switched away from their incumbent supplier, and it should consider ways in which customers who do switch can make more informed choices. Ofgem should also investigate how all customers could benefit from competition, whether they switch or not, for example by preventing energy companies from over-charging their legacy customers.

This is a matter for Ofgem in the first instance.

Transfer of supply and payment methods are valuable tools in reducing households' gas and electricity costs, and the Government shares the Committee's interest in finding new ways of engaging customers and facilitating decision-making and transfer.

The Government has just undertaken a public consultation on draft Social and Environmental Guidance to the Gas and Electricity Markets Authority (closed 26 September 2008). This proposes that Ofgem acts to help ensure that there are no unnecessary barriers to switching.

Payment types

27. There has been a widening gap between companies' direct debit tariffs, and those for standard credit and prepayment meters (PPM). Nine years after liberalisation, this suggests a serious failing in the competitiveness of the market. Recent debate has focused on the prices for PPM. However, we are equally concerned about the poor deal standard credit customers are receiving, particularly given that this is the payment method for the vast majority of the fuel poor and the evidence suggests they are on average being over-charged even more than those on PPM.

28. This issue is a major part of Ofgem's probe. In a fully competitive market the tariff differences for each payment type would not exceed their economic cost; there would be no cross-subsidy between, for example, standard credit and online direct debit customers. The regulator's probe must form a robust view of the additional costs associated with standard credit and PPM customers. If, in a year's time, the 'Big 6' have still not narrowed the gap between the different payment types, Ofgem should consider re-introducing some form of price control, limiting the differentials that can be charged.

As the Committee has noted, Ofgem is currently investigating, as part of its probe into the energy market, the reasons behind the different tariffs charged for gas and electricity. This will include considering whether the extent to which they vary according to the payment method used is fair and justified. We will be looking to Ofgem's analysis to see if it shows whether groups of customers are being treated unfairly.

If Ofgem's analysis does show that disadvantaged groups are facing unjustifiably high charges then we will in the first instance expect Ofgem and the energy suppliers to provide the solution. If sufficient progress is not made by this winter, the Secretary of State will consult on legislation, with a view to reducing any unjustified tariff differentials.

The Government has also asked the Financial Inclusion Task Force to work individually with the energy suppliers, with Ofgem and with other stakeholders to develop new ways to encourage greater use of direct debits. The Taskforce has been asked to report back in

December with recommendations to ensure that more people can benefit from direct debit payments and to make bill payments easier and more affordable for vulnerable customers.

Smart metering

29. We believe smart meters would play an important role in facilitating competition in the retail sector by giving consumers better information about their electricity usage and cost, thus encouraging greater and more informed switching. The Chief Executive of E.ON UK told us: "we should get on with this, because, quite frankly, we are using Stone Age technology here; we know we can do better; we just need to agree the process by which we roll it out". We agree, and hope the Government's decision, due by the end of the year, includes a clear and urgent timetable for implementation.

The Government recognises that there may be potential for smart metering to deliver benefits to domestic consumers, including the potential for facilitating competition. However it is important to be clear about the costs and benefits. Impact assessment work completed to date has identified a number of areas for further work. An in-depth programme of work is therefore underway to develop the evidence base before Ministers take decisions on roll-out later this year. At that point, in the event of a decision to proceed, the next steps on implementation will also be put forward.

The SME Market

30. The evidence put to us by small companies in the market for SME electricity supply is compelling and suggests some of the 'Big 6' companies may be abusing their market position to choke off new entrants. We are also concerned by the role of third party intermediaries. We welcome the fact that Ofgem is considering small business customers as part of its probe. We believe that until now Ofgem has in the past paid too little attention to this important part of the market. If it finds evidence of serious anti-competitive behaviour by specific companies, and is unable to address this situation with suitable undertakings, it should refer the matter to the Competition Commission.

This is for Ofgem in the first instance.

Smaller supplier companies are clearly a vital element of the UK energy market. In addition to increasing competition, their participation encourages a diversity of approach, promotes innovation and allows the development of niche markets. If there are barriers to new entrants or unfair constraints on those small companies already within the market there must be careful consideration of how these can be removed.

The detailed evidence the Committee has collected is important, touching not only on difficulties, such as gaining timely access to wholesale electricity, but also allegations of anti-competitive practices. Like the Committee, the Government welcomes the inclusion of this essential area within Ofgem's probe and looks forward to its analysis of the current situation as well as any potential solutions that could improve the functioning of the market.

Product innovation and 'green' tariffs

31. Overall, there has been a growing level of product innovation in recent years for those customers who are able and willing to engage in the market. However, we have serious concerns that customers on many 'green' tariffs are being misled about the extent to which their tariff offers an additional environmental benefit, over and above their energy supplier's existing legal requirement under the Renewables Obligation. We welcome Ofgem's belated guidelines for suppliers offering green tariffs, and hope that they will reduce the potential for customer confusion. Once in place, Ofgem must monitor compliance with the guidelines closely.

The Government has also welcomed Ofgem's guidelines on green tariffs. It is essential that consumers who wish to take these issues into account when making choices about suppliers and tariffs are provided with appropriate information to allow them to do so.

Off-network gas consumers

32. Many consumers whose homes are not connected to the gas network have the frustration of knowing gas pipelines are close by, but cannot be accessed. They are condemned to using more expensive means of heating their homes. Ofgem should consider whether the current incentives are strong enough to encourage network operators to connect more households to the gas network. It should also consider the appropriateness of the charges involved, especially where communities could club together to pay for such connections. The Government could also consider targeting part of any increase in budgets to address fuel poverty towards schemes to provide direct financial assistance to secure connections to the network, or to assist the development of local combined heat and power or renewable heat schemes for such communities.

Households without access to the gas network are at increased risk of fuel poverty because they rely on fuels that have grown more expensive in relation to mains gas. Other fuels may be physically inconvenient for elderly or other vulnerable customers to use. Ofgem is delivering measures to encourage Gas Distribution Networks to provide connections to deprived communities under the 2008–13 Gas Distribution Price Control. Such connections can be provided in tandem with funding of gas central heating systems under Warm Front, which is funded by the Government.

Ofgem is already able to determine the appropriateness of charges made by distribution networks for the provision of gas connections. The model used to provide connections is likely to draw heavily on that developed by BERR's Design and Demonstration Unit. The Unit's model is also being used with some flexibility in demonstration programmes to provide renewable technologies for households without mains gas. In May, the Government announced that this demonstration activity would be expanded in a new pilot, which would take the form of a fuel poverty workstream under the Low Carbon Buildings Programme. Pilot activity will take place in North East England, Yorkshire and Humberside, the East of England and Wales, in partnership with Regional Development Agencies and the Welsh Assembly.

The Government's draft Social and Environmental Guidance to the Gas and Electricity Markets Authority proposes that Ofgem continue to keep under review the incentives for encouraging gas network extension.

33. We are concerned that there is not sufficient regulatory oversight of the market for domestic fuel for households which are not connected to the gas network. The Government should consider whether both the statutory duties of Ofgem and the successor to Energywatch, the National Consumer Council, should explicitly cover the market for fuels used by off-network households.

The Government will continue to monitor the effectiveness of regulation and consumer support in all energy markets.

The new consumer body Consumer Focus will not be limited, as Energywatch has been, to working for consumers in the mains gas and electricity markets. Consumer Focus will have a particular remit to protect vulnerable customers.

In terms of regulation, the downstream oil industry, including the production and supply of Liquid Petroleum Gas, is not subject to economic regulation in the UK, as the Government believes the market to be highly competitive, operating as it does within a global market comprising many different refiners, traders and suppliers. This represents a different situation from the gas and electricity supply networks regulated by Ofgem, as part of these networks are owned and operated by monopoly companies. In the markets for LPG and heating oil, it is feasible for firms to compete with market incumbents in the transportation and supply of these fuels, because the same infrastructure restrictions do not apply.

The supply of heating oil and LPG is subject to UK competition law under the Competition Act 1998, and the appropriate bodies act to regulate the sector. For instance, as a result of concerns about competition in the market for domestic bulk LPG, the Office of Fair Trading (OFT) made a market investigation reference to the Competition Commission (CC) in July 2004. In June 2006 the CC published a report which stated that difficulties in switching supplier have inhibited competition. The CC has arrived at a package of remedies which is intended to make it easier to switch supplier, and will provide greater transparency of pricing, providing information on which consumers will be able to take this decision. It is expected that the increased ability of consumers to switch supplier will increase competition in the market and put downward pressure on prices.

With these measures in place, the supply of LPG will effectively be regulated by the Office of Fair Trading. The Office of Fair Trading also has powers to investigate allegations of anti-competitive agreements and abuse of any dominant market position in the fuel market.

Final remarks on markets

34. Our overall conclusion on the functioning of both the gas and electricity wholesale markets is that there are significant questions that need to be addressed in the interests of both retail and business consumers. We have also identified important issues that need to be addressed in the retail market itself. We have at this stage, however, recommended consideration of the merits of referring only two aspects of the markets

to the Competition Commission (the forward gas market and the supply of electricity to the SME sector), and then only if Ofgem is unable to take sufficiently robust steps itself. We note that no witness has suggested that there is any evidence of active collusion in the wholesale or retail markets. It is clear, though, that in a retail market dominated by six big players, it is easy for those players to make informed judgements about the behaviour of their competitors. This can distort competition, without any active collusion occurring. The regulator therefore needs to remain very watchful.

35. We believe that there are very real problems that need to be addressed. This can best be done through improving market design, taking specific regulatory steps, and by continuing to work for liberalisation of European markets. Such an approach is more likely to bring real and lasting benefits to consumers. It is also less likely to inhibit the investment the UK needs so urgently if we are to "keep the lights on" as we lose a large proportion of our generating capacity around the middle of the next decade. It will, however, need Ofgem to demonstrate a rather greater sense of urgency than has been made apparent so far. In this context we look forward to reading the conclusions of its market probe in September.

The Government agrees the importance of continuing to improve the functioning of markets where appropriate while providing sufficient regulatory certainty to ensure continuing necessary investments to safeguard supply in the future. We look forward to the results of Ofgem's investigation.

Recent developments in fuel poverty

36. Other things being equal, with every 10% increase in energy prices 400,000 people go into fuel poverty. The rise in prices since 2004 means the Government is certain to miss its target of eradicating fuel poverty for vulnerable households by 2010. We welcome Ofgem's Fuel Poverty Action Programme as a sign that the Government is aware of mounting concern in this area. In particular we welcome plans to enable data-sharing that will help energy suppliers identify pensioners most in need, although such information will need to be handled with the utmost propriety. We hope the Government will implement similar plans for other vulnerable groups. However, in the context of sharply rising prices and reductions in funds for the Warm Front programme, discussed below, the additional money pledged by the energy companies, while welcome, will make very little difference to the overall number of fuel poor households. We believe the Government must now consider a fundamental re-think of its approach to tackling fuel poverty.

The Government is deeply concerned about the effects of energy price rises on UK households, and particularly on vulnerable people. We have now launched a number of new initiatives to respond directly to the challenge of rising energy bills and improve the effectiveness of the fuel poverty strategy. These initiatives involve working closely with the energy suppliers to see how best they can help their most vulnerable consumers, and how the Government can help them identify those who are mostly in need of help. As a result, suppliers have agreed voluntarily to spend more on their social programmes, rising to £150 million by 2011; this represents a substantial form of assistance through social tariffs, rebates, debt advice, trust funds and benefits entitlement checks.

On 11 September the Government announced a £1 billion Home Energy Saving Programme to help domestic consumers cut their energy bills permanently. Within this, we are expanding the Carbon Emissions Reduction Target (CERT) by 20%, an obligation on energy suppliers to install energy efficiency measures in households. This will mean a further £560 million energy supplier investment in GB housing; 40% of these measures have to be installed in a priority group of low income and elderly households. The Government also announced a further £74 million for the Warm Front Scheme, an increase in the Cold Weather Payment for this winter from £8.50 to £25 per week, and plans to work with energy companies and the banks to increase the number of people using direct debits to pay their energy bills. We will continue to keep fuel poverty policies under constant review to ensure that the Fuel Poverty Strategy and the Government's policies, initiatives and measures are fit for purpose to respond to new challenges.

Social tariffs

37. In rethinking its approach to fuel poverty the Government must decide whether companies should have a larger, perhaps statutory role to play in delivering its social policy objectives—that is, to what extent energy companies should be expected to divert their profits away from investment and distribution to shareholders, and to what extent relatively more affluent energy consumers, many of whom are themselves far from rich, should, through the price they pay for their electricity, cross-subsidise those who are less well-off. This cross-subsidy is currently modest, but it would inevitably grow if social tariffs were to be expanded.

38. Energy suppliers' existing social assistance initiatives (which go well beyond specific tariffs) do not reach the vast majority of the fuel-poor. They also vary widely, confusing consumers and providing inconsistent coverage. Irrespective of its broader conclusions on the role of such tariffs, we believe the Government should define the criteria for both the prices charged by suppliers under the banner of social tariffs, and for identifying those customers that qualify for them. We recognise that companies could only implement such an approach if they have access to information provided by central and local government. We do not accept the view that a mandatory and comprehensible definition of what constitutes a social tariff would create a 'race to the bottom' for all suppliers—rather, it would provide a minimum level above which they can compete, not only on tariffs, but also on other schemes to assist the fuel-poor.

The Government recognises the key role energy suppliers have in helping us tackle fuel poverty. While some years ago suppliers did not offer a social programme, they are all now investing substantial amounts voluntarily to help their most vulnerable customers. Around 600,000 customers are expected to benefit from discounted bills by the end of the year as a result of the agreement between the Government and the companies for an additional £225 million spending on reduced tariffs and other social programmes over the next three years. Around three quarters of these bills will be guaranteed not to have price increases this winter.

The Government believes that a voluntary approach has brought considerable benefits in that it has allowed energy companies to innovate and tailor-make their offers to suit their customers. Mandating a single approach could risk the suppliers offering the minimum required to comply with the Government's requirements, when we know, through Ofgem's independent reporting on social programmes, that suppliers offer innovative approaches and keep refining their targeting methods to get to those who need them the most.

In addition, in its recent guidance,[5] Ofgem stated that a tariff can only qualify as a social tariff if it is the cheapest tariff offered by a supplier in the customer's region. This will clarify the uncertainly regarding what constitutes a social tariff and will give confidence to those who are eligible that they are receiving the best tariff available to them.

Raising incomes

39. The Winter Fuel Payment is targeted at pensioners rather than the fuel-poor. The political reality is that either removing it from any existing recipients, or taxing it, to release funds for the genuinely fuel-poor, would be courageous decisions. However, we believe that any additional funds to help households cope with rising energy prices should be better targeted on the fuel-poor—not only pensioners, but also disabled people and other vulnerable consumers.

The Government notes the proposal to extend Winter Fuel Payments to other groups. Winter Fuel Payment are made to people aged 60 or over, because older people are particularly vulnerable to the effects of cold weather in winter months. Increases in death rates in winter are greatest among the elderly. In the winter of 2006/07 there were 22,300 more deaths among those aged 65 and over compared to levels in the non-winter period. In contrast, there were fewer than 2,000 more deaths among those under the age of 65. In addition, around half of all people with limiting long standing illnesses, impairments or disabilities are aged 60 or over.

Winter Fuel Payments give reassurance to older people that they can afford to turn up their heating in the winter months without worrying about the cost. In keeping with the Government policy of support for all and more for those who need it most, it was decided that the payment should not be based on income but rather should be available to all pensioner households by way of a simple qualifying rule. Targeting the Winter Fuel Payment only on those on low income would exclude a large proportion of the pensioner population who are likely to be on fixed incomes and who may find it difficult to budget for winter bills.

Help is available for low income households through other benefits and payments such as Income Support and income-based Jobseeker's Allowance. For disabled people under 60, help is available through disability benefits and the disability premium in income-related benefits. These benefits and premiums are in recognition of the extra costs—including heating—which coping with a disability may incur. Around 60% of people who receive Disability Living Allowance or Attendance Allowance are aged 60 or over and automatically receive a Winter Fuel Payment. And, where a disability premium is paid in an income-related benefit, such as income support or income-based Jobseeker's allowance, a Cold Weather Payment is payable in periods of very cold weather. Cold Weather Payments are also made automatically to other vulnerable people on income-related benefits, including those with responsibility for a child under five. The Government

[5] http://www.ofgem.gov.uk/Sustainability/SocAction/Suppliers/CSR/Documents1/Monitoring_suppliers_10508.pdf

announced, as part of its Home Energy Saving Programme, that the level of Cold Weather Payments for the coming winter, 2008/09, will be increased from £8.50 to £25 a week.

Improving housing

40. After several years of increases, it is very disappointing that in the current three-year spending period the Government has reduced the budget for Warm Front at a time when the need for it is greatest. This is especially so, given that HM Treasury has received additional income from the auctioning of permits under Phase 2 of the EU Emissions Trading Scheme, while electricity generators are benefiting from windfall gains from the free allocation of the majority of permits under the same scheme. We hope that this reduction in funding will be corrected very quickly.

41. We recognise the claims made by the generators about the way in which they have used the 'windfall gains' under Phase 2 of the EU ETS, and we understand the danger that regulatory uncertainty could delay investment plans. However, given the apparent size of the gain (something we have already asked Ofgem to examine more carefully), and the extreme need of many households, we believe there is a compelling rationale for at least a modest, one-off top-slicing of these gains to help fund action to reduce the energy bills of vulnerable families in the long term. However, we also note the windfall gains accruing to HM Treasury, and believe it too must make its contribution in these exceptional circumstances.

The Government is ensuring that increased resources are available to provide support for energy efficiency and heating measures in low income and vulnerable households, and it is important to consider the range of relevant policy interventions, not solely the Warm Front programme. Resources for vulnerable households were to increase by £680m to £2.3 billion over 2008-11 through the combination of Warm Front and Carbon Emissions Reduction Target Priority Group. The package of home energy saving measures announced by the Prime Minister on 11 September 2008 provides for substantial further activity to help the Priority Group under CERT, and for a proposed new £350 million Community Energy Saving Obligation. This will create partnerships including (but not limited to) local councils and community-based organisations, voluntary organisations and energy companies to go street-by-street through communities offering free and discounted central heating, energy efficiency measures and benefit checks. Areas will be selected based around those with higher levels of deprivation, and measures will be developed for both vulnerable households and those in the able-to-pay sector. This programme would be funded through a new and additional obligation on energy suppliers and electricity generators. In addition, further funding of £74 million has been allocated to Warm Front over the next two years as part of the package.

As a result of these various measures, the money spent by energy companies on meeting their obligations is expected to increase in total by £910 million. This would add to the £2.8 billion already required of suppliers under the existing CERT obligation.

42. Energy prices are likely to remain high, by historic standards, and the Government is unlikely to be able to raise incomes sufficiently rapidly to meet its fuel poverty target, especially given the current economic downturn. This means that in the future, government and industry efforts need to focus on improving the housing stock of the

fuel-poor, as the most cost-effective means of reducing both their energy bills and their carbon emissions. We believe the Government must consider whether the Carbon Emissions Reduction Target and Warm Front should be more precisely focused on helping the fuel-poor, and whether synergies between the two initiatives can be more actively exploited. If the Government remains committed to eradicating fuel poverty it must have in place policy instruments specifically designed to achieve this aim that do not rely on ongoing subsidy of fuel bills. A great many households face a difficult winter; it is imperative that the Government reviews its approach to fuel poverty and does so urgently.

The Government agrees with the Committee that improving the energy efficiency of the housing stock is key to tackling fuel poverty. The energy efficiency programmes this Government has put in place play a critical role in not only assisting households in fuel poverty but also future proofing households from falling into fuel poverty.

Already we have been trialling approaches. Through our Community Energy Efficiency Fund we provided £6 million over the last year in start-up funding for some 49 partnerships to provide a cost effective way of delivering CERT and Warm Front over the next three years using a targeted local approach. This is expected to lever in over £100 million of private sector funding. Building on this, the Government announced in April 2008 its intention to launch a new green neighbourhoods programme. We have asked the EST to develop a community based approach which helps up to 100 selected neighbourhoods in England reduce their carbon footprints by 60%. The programme will make it easier, cheaper and simpler for neighbourhoods to take whole house low-carbon action. It will specifically aim to demonstrate what can be achieved with older housing stock, the 'hard to treat' homes. The EST aim to launch a competition for funding proposals by the end of the year, with first successful projects being funded from April 2009.

The £1 billion Home Energy Saving Programme described above aims to help domestic consumers cut their energy bills permanently. As we have stated, we are expanding CERT by 20%, an obligation on energy suppliers to install energy efficiency measures in households. This will mean a further £560 million energy supplier investment in GB housing. 40% of these measures have to be installed in a priority group of low income and elderly households.

Currently, under this scheme, the over 70s or those on qualifying benefits can benefit from measures such as loft insulation (where less than 60mm) and cavity wall insulation, for free. All other households can get energy saving measures at a substantial discount. Such measures can, in combination with simple energy saving actions, save households over £300 per year on their energy bills. In addition, the Government will consult on legislation for a new £350 million obligation on energy suppliers and electricity generators to undertake community-based energy efficiency measures. To make sure people across the country can take advantage of the help on offer and save as much money as possible, a national TV, press and online social marketing campaign will publicise what help is available.

As mentioned in the previous section, the Government also announced a further £74 million for the Warm Front Scheme—the Governments flagship fuel poverty programme, and an increase in the Cold Weather Payment for this winter, from £8.50 to £25 per week.

In terms of targeting, energy suppliers use a variety of innovative methods to identify priority group customers including setting out the priority group criteria in promotional material; partnership arrangements with bodies like social housing providers and charities that work with priority group consumers, as well as work with local authorities. As part of this, the Warm Front programme has an established history of working with energy suppliers who are looking to achieve their CERT targets. Through these relationships the vast majority of households receiving insulation measures through Warm Front Scheme have their measures funded through CERT. This provides benefits to the householder through freeing up more of their Warm Front grant for other measures and provides a more joined-up form of measure delivery. We are also consulting on giving the Energy Saving Trust access to the information contained in Energy Performance Certificates, so that they can target those in the least energy efficient properties with advice and information on energy supplier offers.

To make sure people across the country can take advantage of the help on offer and save as much money as possible, a national TV, press and online social marketing campaign now launched will publicise what help is available.

2 October 2008