Labour's Policy Review

Real Energy Market Reform

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REAL ENERGY MARKET REFORM

The energy market must be radically reformed so that people pay a fair price for their energy

Energy bills are soaring, up by £200 in the last two years, and contributing to the cost of living crisis afflicting millions of families across the country. The energy market is dominated by just six companies; in fact 99 per cent of households get their energy from one of the 'Big Six'. This lack of competition means energy prices are higher than they might otherwise be. A recent report by IPPR suggests that with more competition in the market, bills could be as much as £70 less per year. To add to this, switching between energy suppliers reached its lowest ever level in the first quarter of 2012 – not because customers are happy with their energy providers, but rather because there has been a loss of faith in the energy market.

But this Tory-led Government is out-of-touch, out-of-date and puts the interests of the big energy companies ahead of ordinary families and pensioners struggling with soaring energy bills. The Government's Draft Energy Bill has nothing to help families struggling to make ends meet. Their only answer so far has been to say that customers are to blame for not shopping around enough and, at the same time as energy bills are rocketing, the Government has cut back the support it is offering to help people heat their homes.

The Prime Minister's recent announcement that the Government would be "legislating so that energy companies have to give the lowest tariff to their customers"[1] unravelled within 24 hours, and all the Government is actually doing is getting the energy companies to write to people. The Government is not prepared to stand up to powerful vested interests. They have backed business-as-usual in the energy market and refused to challenge the practices, pricing and structure of the energy market, and the need for urgent reform.

A Labour Government would do three things to reform the energy market. We would abolish Ofgem and create a tough new energy watchdog with the power to force energy companies to pass on price cuts when wholesale costs fall. We would require the energy companies to pool the power they generate and to make it available to any retailer, to open up the market and make it more transparent. We would also require energy companies to put all over-75s on their cheapest tariff, which could save as many as 4 million pensioners as much as £200 a year from their annual energy bills.

[1] David Cameron, Prime Ministers Questions, 17 October – 2012
http://www.publications.parliament.uk/pa/cm201213/cmhansrd/cm121017/debtext/121017-0001.htm#12101758000008

What has gone wrong with the energy market?

Improving the perception that profits are fair is essential for increasing consumer engagement with the energy market.

Since 2008, the number of people switching energy supplier has fallen by 50 per cent, and switching levels are now at the lowest level on record[2]. At a time when energy bills have increased sharply, and when complaints against energy suppliers are at near-record levels, it is not credible to suggest that people are staying with their existing supplier because they are satisfied.

Unlike most retailers, energy companies sell us a product that we all have to buy; people cannot choose to opt-out of buying energy. There is, therefore, a strong case for arguing that energy needs regulation of a different order to almost all other goods and services, and that even consumers who do not wish to engage with the market, should be protected from being ripped off.

At the moment, any attempt to accurately estimate the true costs of energy supply is hampered by the lack of publicly available information. All of the 'Big Six' energy companies both generate and retail power. That means the cost to them of energy is not reflected in the wholesale price. These vertically integrated companies have every reason to keep wholesale prices high, as it enables them to remain profitable while claiming their retail margins are low. The wholesale market is only an indication for energy prices – not a definitive guide, because electricity is predominantly bought and sold through bilateral trades that aren't public.

Prices and levels of profits should be set by a properly functioning competitive market. But there are strong grounds for believing that liberalisation has not led to a properly functioning competitive market.

The domination of the market by six businesses does not, in itself, indicate that competition in that market is ineffective. However, the fact that since liberalisation no new entrant has achieved anything like the scale of operations to challenge the 'Big Six' suggests there are significant barriers for newcomers. Energy companies frequently assert that electricity and gas prices in the UK are among the lowest in Europe. However, this is only true when tax is included (because UK tax levels for gas and electricity are comparatively low), and tax is a government instrument, not a feature of market efficiency. When tax is not included, the UK compares much less favourably. In 2011, UK electricity prices (in pence per kWh) were 5.3 per cent higher than the EU-15 and G7 median and 19.1 per cent higher than the EU-27 median. UK gas prices (in pence per kWh) still compare favourably, although in 2011, for the first time, the UK gas price was above the EU-27 median[3]. Although international comparisons are an imperfect measure of market efficiency, they do suggest there may be scope for greater efficiencies.

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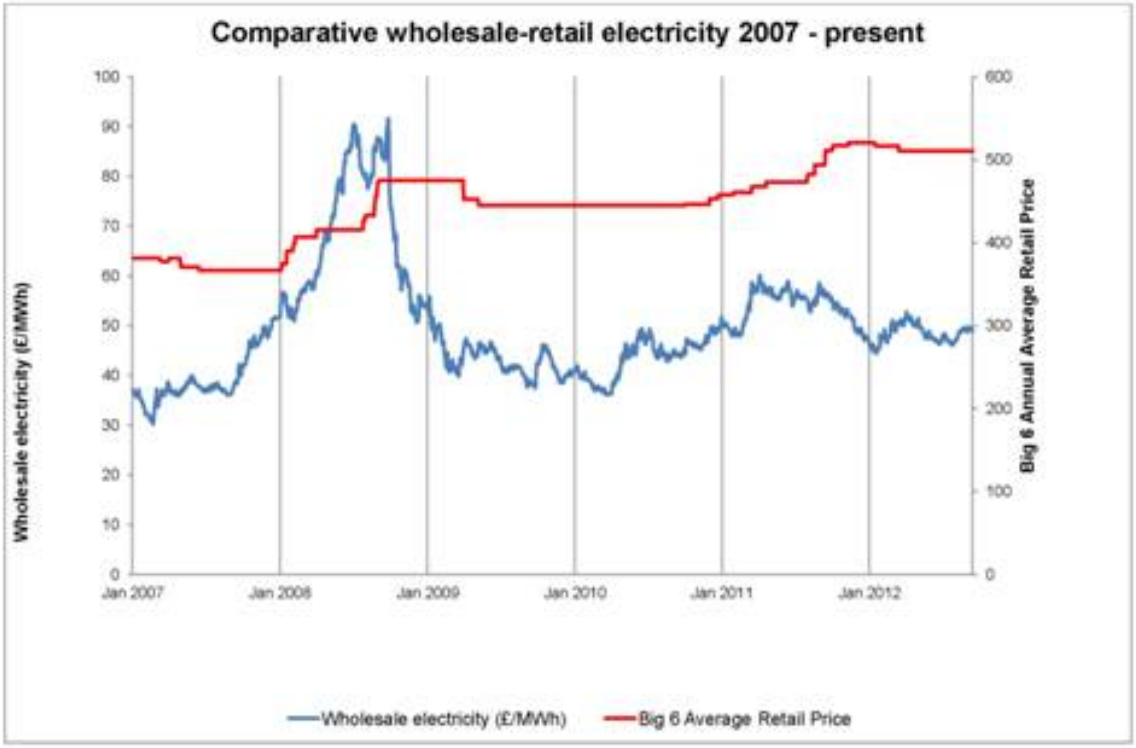
[2] In quarter 1 of 2012, just 746,000 people switched electricity supplier and 533,000 switched gas supplier compared to 1,494,000 people who switched electricity supplier and 1,137,000 who switched gas supplier in quarter 3 of 2008.
Source: HC Deb, 11 June 2012, c187W & HC Deb, 16 July 2012, c526W.

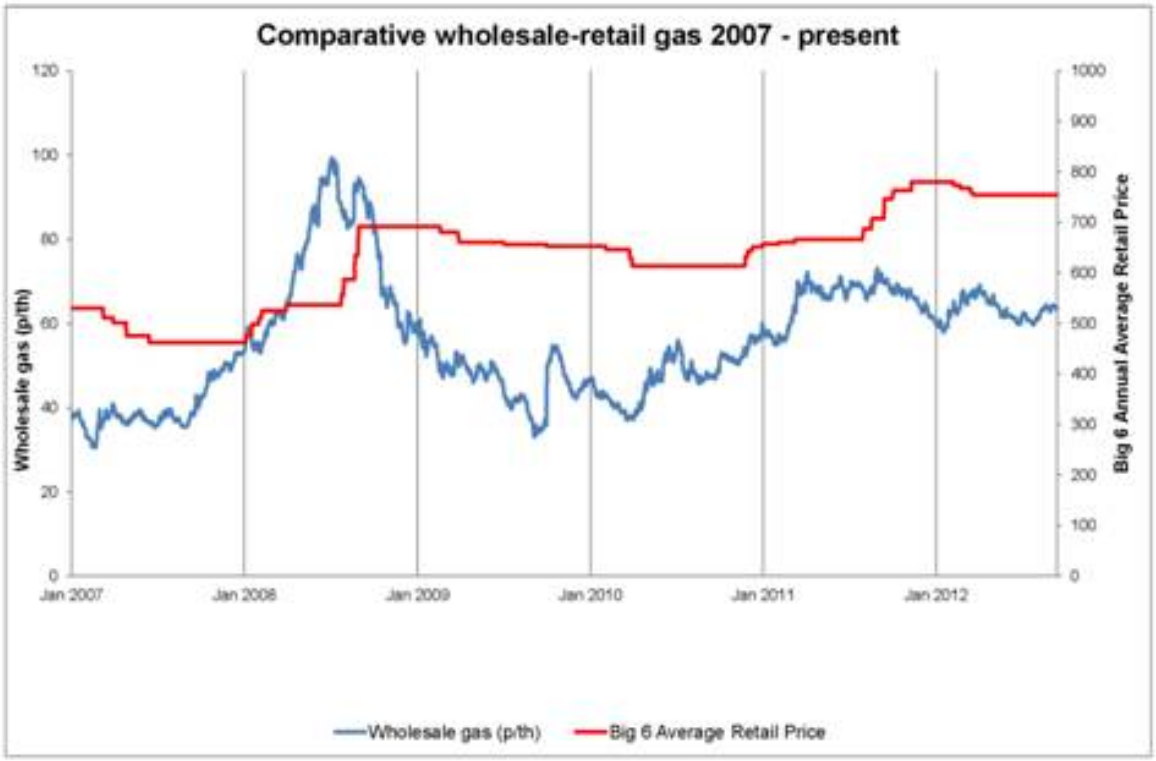
[3] Department for Energy and Climate Change [DECC] (2012) *Quarterly energy prices*, London.

If pricing is competitive wholesale cost falls should be passed on as quickly as cost increases. In 2011, Ofgem themselves found evidence that energy suppliers were slower in passing on reductions in wholesale energy costs than they were increases[4]. Analysis by the consumer watchdog Consumer Focus has also found a gap between the price energy companies buy electricity and gas at, and what they sell it to the public for. Their research shows that even though the wholesale prices of electricity and gas have both fallen since 2008, retail prices for both are still significantly higher in 2012 compared to 2008[5].



[4] Ofgem. (2011). *Do energy bills respond faster to rising costs than falling costs?* *http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/Price_Asymmetry.pdf*

[5] http://www.consumerfocus.org.uk/policy-research/energy/paying-for-energy/wholesale-retail-prices



Reforming the energy market

To make sure people are paying a fair price for the energy they use, we need to tackle the root cause of the problem, and to do that we need a radical overhaul of the energy market. We need to open up the market so that there is more competition and greater transparency.

We would force the energy companies to pool the power they generate and to make it available to any retailer, in an attempt to open the market and to put downward pressure on prices.

Energy companies always cite wholesale prices as the reason for bills going up, but bills never seem to get reduced to a similar extent when the wholesale price falls. One of the reasons energy companies can get away with this is because of the complex and opaque way in which energy is sold. At the moment, most energy is bought and sold through secret bilateral deals between energy companies. As a result, no one really knows what the true wholesale cost of energy is.

Requiring energy companies to put all the power they generate into a pool, allowing any retailer to bid for that energy and sell it on to the public, will make the market more transparent. It will stop the secret deals and prevent energy companies selling power to themselves before selling it on to the public. The pool will allow other

companies to become suppliers of household energy, increasing competition which in turn should help to drive down prices.

We would abolish Ofgem and create a tough new energy watchdog with a statutory duty to monitor wholesale and retail energy prices, and the power to force energy suppliers to pass on price cuts when the cost of wholesale energy falls.

Requiring all energy companies to put all the power they produce into a pool, which anyone could bid to retail, will allow us to establish a clear wholesale reference price for energy, which could be used as benchmark to measure any increases or decreases. With this information, the new energy watchdog could establish when wholesale prices are rising and falling, and accurately monitor the relationship between wholesale and retail prices, which is effectively impossible at the moment. This would enable a regulator, with the right powers, to either (a) force energy suppliers to reduce their retail prices in line with wholesale cost reductions or (b) take some enforcement against suppliers that failed to pass on reductions in wholesale costs in a timely manner.

We would require energy companies to put all over-75s on their cheapest tariff, which could save as many as four million pensioners as much as £200 a year from their annual energy bills.

Elderly customers are among those least likely to investigate cheaper tariffs and switch suppliers, with the lowest levels of IT literacy and awareness of the savings they could make in their bills by switching providers. Research by Ofgem has shown that pensioners are less likely to switch supplier than average consumers[6].

We would require energy companies to put all over-75s on their cheapest tariff. This would ensure that up to 4 million pensioners would benefit from lower bills for their gas or electricity.

[6] Ofgem. (2008) *Energy Supply Probe - Initial Findings Report* http://www.ofgem.gov.uk/Markets/RetMkts/ensuppro/Documents1/Energy%20Supply%20Probe%20-%20Initial%20Findings%20Report.pdf

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