

June 2002

**Regulation of gas and electricity
marketing: a more rigorous approach**

A consultation document

Executive summary

Since the introduction of competition into the gas and electricity supply markets the industry has made full and effective use of direct selling as a channel to market - on the doorstep, by telephone and in public places such as supermarkets. This has resulted in high levels of consumer switching which has in turn provided significant consumer benefits, for example through lower tariffs.

However, Ofgem recognises that the small proportion of direct sales contact which is not conducted appropriately can cause great distress to the consumers involved. Direct selling activity is regulated by conditions in the gas and electricity supply licences, which are monitored for compliance and enforced by Ofgem. Ofgem is committed to enforcing these rules effectively, and is therefore proposing a tougher approach to compliance and enforcement of the marketing licence condition. This new approach will result in prompter action and will lead to the imposition of sanctions against those companies that continue to breach their licences. These could include substantial financial penalties.

This document sets out for consultation Ofgem's revised approach to investigating possible breaches of the licence condition. An initial interim threshold for investigation will be set: a supplier will be above it when it is one of the two worst performers for two consecutive months. Once energywatch's new database and process have established sufficient robust data points for a forward view to be possible, the threshold will be reset as a number of complaints to energywatch, per thousand transfers. This number will be calculated as being a certain percentage above the industry average during a reference period. Performance will be analysed in terms of complaints per thousand transfers, rebased to the month when, on average, the experience about which the customer is complaining took place; i.e., two months previous to the complaints being received.

The document also consults on the kind of enforcement action which will be taken. Based on an investigation both of customer experiences and of supplier processes, Ofgem's governing Authority will take a view on whether a substantial financial penalty should be imposed, or other sanctions applied. The fact of the investigation and its outcome will be made public.

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1. Introduction

Background

- 1.1 Since the introduction of competition into the gas and electricity supply markets the industry has made full and effective use of direct selling as a channel to market - on the doorstep, by telephone and in public places such as supermarkets. This has resulted in high levels of consumer switching between suppliers which has in turn led to significant consumer benefits, for example through lower tariffs.
- 1.2 Direct selling to domestic customers is regulated by standard licence condition 48 of both the gas and electricity supply licences. Following evidence of misselling, these conditions were amended in January 2001 and again extended for a further two years from April 2002. Ofgem now proposes to strengthen its approach to the regulation of direct selling. We have consulted on the way in which the licence conditions can be made more effective and we will shortly be commissioning a programme of consumer research. This paper considers how compliance with the existing conditions can be enforced more effectively in the meantime.
- 1.3 Direct selling has brought benefits to many consumers and complaints about direct selling have reduced since the introduction of competition. However, Ofgem remains concerned about the complaints that are still reported. While these are proportionately few, the absolute numbers of consumers involved are large, and we recognise that problems of marketing can be serious for the consumers involved.
- 1.4 Ofgem is aware of a range of incidents involving vulnerable customers. Ofgem has also received numerous reports of entirely unacceptable practices such as misleading customers as to the nature of sales material, misleading customers as to prices and intimidation of customers. Ofgem regards these practices as completely unacceptable. Experience shows that, although the management of direct sales to the public is not necessarily easy, focused and determined management can prevent most abuses of this kind. Across the range of energy suppliers today, some succeed in marketing their services without a high level of

mis-selling, while others demonstrate persistent failure to get to grips with this issue.

- 1.5 Ofgem has previously employed a medium-term approach to enforcing the requirements of the marketing licence conditions, applying improvement targets and allowing companies significant periods of time to achieve them. This method has been successful in improving the performance of individual companies but has been criticised as being too slow and lacking in transparency. The measures have not created sufficient incentives for other companies to improve performance and so have not driven a sufficient overall improvement in industry standards.
- 1.6 In May 2002, Ofgem announced that it would be publishing a revised enforcement process. This paper gives interested parties an opportunity to comment on the details of that process.

Industry context

- 1.7 Ofgem considers that the resolution to the problem of energy misselling will be achieved through the concerted efforts of all participants, suppliers, the regulator and energywatch. While Ofgem is keen to play its part in ensuring no supplier can opt out of effective management of direct sales, we are pleased by the recent expressions of willingness by suppliers to improve the industry's self-regulatory arrangements.
- 1.8 In particular, Ofgem is awaiting with interest suppliers' development of a code of practice and arrangements for a neutral third party to audit suppliers' compliance with it. At the recent Energy Selling Steering Group Ofgem and energywatch agreed with industry representatives some principles which this drafting should incorporate. These are:
- ◆ compliance with the legal and regulatory requirements;
 - ◆ design and deliver from a consumer perspective;
 - ◆ all elements in the code should allow for measurement of performance;
 - and

- ◆ clearly defined sanctions

- 1.9 In addition, Ofgem believes that an industry code of practice could usefully expand on the licence obligation to pay compensation to customers where appropriate. We believe it should include the automatic payment of significant amounts of compensation to consumers for cases of misselling.

Rationale

- 1.10 Ofgem believes that direct selling has made a significant contribution to the establishment of effective competition in the gas and electricity supply markets, but is concerned that the continued high profile of cases of misselling will undermine consumer confidence in the transfer and switching process.
- 1.11 Ofgem believes that publication of the compliance and enforcement process will be of value to both suppliers and consumers. By publishing the shorter timescale during which action may be taken, Ofgem intends to reassure consumers. Ofgem also aims to give suppliers clarity about its approach, and to provide a signal that failure to resolve the problems of misselling may lead to the imposition of financial penalties and result in negative publicity for the companies concerned.

Timetable

- 1.12 Subject to the results of this consultation process, it is proposed that the new process will be implemented from 1 August 2002 and will make use of the statistics that are available to Ofgem at that time.

Existing arrangements

- 1.13 Given the importance of reducing current rates of misselling, Ofgem does not believe the publication of a new enforcement process should lead Ofgem to suspend any existing investigations of suspected non-compliance with licence conditions. Under the existing process the performance of some suppliers has already triggered an investigation. In the interim Ofgem will apply the new approach to investigation and penalties in these cases.

Comments invited

- 1.14 Comments are invited, by 15 July, and these should be sent to:

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- 1.15 It is open to respondents to mark all or part of their responses as confidential. However Ofgem would prefer that all responses are provided in a form that can be placed in the Ofgem library.

2. The proposed enforcement process

2.1 Ofgem proposes to follow a process as follows:

- ◆ Ofgem will focus its investigation on suppliers whose performance is worse than a published threshold;
- ◆ the investigation will look at the supplier's internal processes, and at the experiences of consumers;
- ◆ where licence breach is established, the Gas and Electricity Markets Authority would consider whether a financial penalty is justified, and consider making an enforcement order;
- ◆ the fact of an investigation and its results will be made public.

Threshold for investigation

2.2 Ofgem gains intelligence about the impact of direct selling from several sources, including the media, the Government and consumer organisations. However the most broad-based input comes from the Gas and Electricity Consumers' Council (energywatch). energywatch reflects customer experience through the complaints that it reports.

2.3 energywatch records and reports a complaint after a consumer has given the supplier an opportunity to resolve it. Ofgem categorises energywatch complaints as direct selling, transfers and customer account complaints.

2.4 energywatch has recently introduced a new database to record complaints which is intended to provide statistics more quickly and allow more effective analysis of the data. At the same time, energywatch has agreed to allow suppliers an opportunity to verify that complaints have been correctly categorised and recorded at an appropriate time.

2.5 The number of direct selling complaints received by energywatch about a supplier can indicate that the supplier may be breaching the conditions of its

licence, although it does not provide direct evidence of this. Ofgem considers the absolute number of complaints in the context of the level of transfer activity undertaken by a supplier in a given month, so complaints are expressed as a number per thousand transfers.

- 2.6 Ofgem currently decides to investigate licence compliance when a supplier has failed to reach a target threshold. The existing threshold has not been published. We intend to set a new threshold and make this known publicly.
- 2.7 In setting the threshold for investigative action, Ofgem has considered a range of issues. These have included the importance of licence compliance as an absolute legal obligation, and also the value of comparison between suppliers to judge reasonableness; the need to set a target which is achievable; the desirability of the threshold remaining stable over a period, and also of reflecting industry-wide improvement in performance; the extent to which consumers' awareness of energywatch's existence has had or may have an impact on the number of complaints; the possible impact of new energywatch procedures, including for suppliers to comment on complaints as they are received.
- 2.8 Taking these factors together, Ofgem recognises that there is considerable scope for fluctuation in the levels of complaint reported over the next few months: because of new categories associated with energywatch's new database; because of the new supplier involvement in the process; because of growing awareness of energywatch's existence; and because of energywatch's improving internal systems which make it easier for consumers to contact it. In the short term, therefore, Ofgem proposes to adopt an interim threshold, which will be defined in a way which does not require comparison between complaints statistics in different months. Once a reasonably stable pattern emerges in complaint statistics, the threshold will be re-set on a basis which gives suppliers a clear forward target.

Interim threshold

- 2.9 The interim threshold will be designed to target Ofgem's resources on the worst performers. It is proposed to mount investigation against a supplier where it:

- ◆ is one of the two worst performers (i.e., has the largest proportion of direct sales complaints per thousand transfers), provided that its performance is worse than the industry average, and it has more than nine complaints;
 - ◆ falls above this threshold for two consecutive months.
- 2.10 It is recognised that this does not give suppliers a forward “target”. However, Ofgem believes that, in practice, the suppliers likely to cross this threshold are in receipt of a large number of complaints from customers, and should therefore already be aware that they have a significant problem. Since this threshold is only for investigation, and does not in itself represent a judgement as to whether the licence has been breached, Ofgem believes it is reasonable to proceed on this basis in the short term.
- 2.11 The threshold will be measured in terms of the aggregate of all gas, electricity and dual fuel direct selling complaints. This is so as to reduce the risk of a marginal misallocation of complaints between categories distorting the outcome. Aggregating complaints allows a larger numerator, and so will reduce the sensitivity to marginal error. Ofgem recognises that this approach creates some possibility of missing licence breaches concentrated on sales of only one fuel, but considers that, since the large majority of customers now buy a dual-fuel package when they switch, this risk is small.
- 2.12 Ofgem will also operate a *de minimis* threshold, so that investigation will not be undertaken of suppliers against whom fewer than ten complaints to energywatch per month have been logged. (However, see paragraph 2.24; cases of gross abuse are liable to attract investigation, however small the supplier involved.)

Medium term threshold

- 2.13 Over the medium-term, the threshold will be a fixed number, which will be set in a particular month to apply over a number of following months. It will be calculated by reference to the average industry performance plus or minus an x factor which will act as an incentive to improve overall performance. (The industry average will be calculated as the average of the sum of gas, electricity and dual fuel complaints over a reference period, divided by the sum of gas and

electricity transfers over a period rebased to take account of the lag between customer contact and complaint – see paragraphs 2.17 to 2.18.)

- 2.14 The threshold will be set in this manner, initially once the new energywatch system for reporting complaints has been running successfully for at least three months. When Ofgem believes that the new system has reached an adequate level of robustness and provided sufficient data, then we will publish a further document; this is expected to be by the end of 2002. The subsequent threshold will run for a minimum of six months before a further review, unless any relevant licence modifications are introduced (see paragraph 1.2).
- 2.15 Subsequently the threshold may be made more specific as energywatch becomes able to provide robust data detailing a further breakdown of the types of complaints within the direct selling complaint category. This could allow for a different threshold to be applied to each lower level category.

Rebasing the denominator

- 2.16 Ofgem is reviewing the way in which it uses transfer data to provide the context for the absolute number of complaints. Experience suggests that following an initial sales contact, consumers do not make an immediate complaint to energywatch, indeed unless they have made contact with a supplier their enquiry will not be recorded as a complaint. Ofgem believes that it would be better to take account of the resulting time lag.
- 2.17 energywatch has indicated that it believes the time lag to be approximately two months, and Ofgem has asked energywatch to verify their estimate of the time lag. In the meantime, in analysis relating to thresholds, Ofgem will rebase the denominator to transfer levels two months before complaints were received by energywatch.

The investigation

2.18 The investigation will follow the procedural steps set out below:

Month 1 energywatch reports direct selling complaints data which show complaints against supplier *y* have exceeded the threshold.

Month 2 energywatch reports direct selling complaints data which show complaints against supplier *y* have exceeded the threshold.

Ofgem asks energywatch for details of all direct selling complaints, about supplier *y*, that have been received during the reporting period.

Ofgem sends an information request to the supplier asking for evidence of compliance with the licence conditions.

Ofgem announces that it is beginning an investigation.

Month 3 Ofgem investigates individual cases.

Month 4 Ofgem writes to supplier *y* to offer a further opportunity to comment.

Month 5 A report is made to the Gas and Electricity Markets Authority, which will decide, in accordance with its published policy, if it considers that it is appropriate to impose a financial penalty. The Authority may equally determine to impose no sanction, or to make an enforcement order as well as or instead of a financial penalty.

Month 6 If the Authority decides to impose a financial penalty, then it will follow the procedural steps outlined in the April 2001 document "Financial Penalties – The Process".

Ofgem will give due publicity to its decision

- 2.19 Ofgem regards the publication of its investigative process as sufficient notice to licence holders.
- 2.20 In assessing a breach of the licence conditions, the Authority will take account of both the impact on consumers, individually or collectively, and the extent to which appropriate processes were in place to limit the likelihood of a breach.

The imposition of financial penalties

- 2.21 Under the Gas Act 1986 and the Electricity Act 1989, as amended by the Utilities Act 2002, the Gas and Electricity Markets Authority, has powers to impose financial penalties.
- 2.22 The statutes require the Authority to prepare, consult and publish a statement of policy on the imposition of financial penalties. That policy was published in April 2001. The Authority also published the procedural steps it would take in exercising its powers to impose financial penalties.
- 2.23 A flow chart describing the statutory process is attached at annex 1.

Communications

- 2.24 Ofgem believes that, given the public interest about this issue, it is appropriate that the investigation process should be transparent and that the outcome of any investigation, including the imposition of financial penalties, should be published. Ofgem recognises that publicity can have a significant impact on suppliers and believes that it will act as a further incentive to improve performance.

Practical application

- 2.25 This document is intended as a general guide to suppliers, consumers and consumer organisations. However, Ofgem will always have to have regard to the seriousness of individual cases that are referred for consideration from whatever source. If, at any time, Ofgem is provided with the details of a potential breach which it believes warrants immediate investigation, it will initiate such an investigation, which can lead to the imposition of penalties, including financial penalties.

Appendix 1

1.1 Stage 2 – Implementation of Statutory Process to be published

