



OPEN LETTER ON OFGEM'S REVIEW OF BRANDING IN THE ELECTRICITY DISTRIBUTION AND SUPPLY MARKETS

27 January 2005

Dear Sir/Madam

Purpose

The purpose of this open letter is to provide further information on Ofgem's review of branding in the electricity distribution and supply markets. Ofgem undertook the review in response to concerns following the re-branding or proposed re-branding of some electricity supply and distribution businesses in common ownership and a need by companies for clarity in this area.

Background

Branding is an important feature in all competitive markets including the gas and electricity supply markets. The presence of recognisable brands in a market, along with informative advertising, can alert customers to the choices available to them. This helps customers to make informed decisions in choosing their energy supplier. Branding and advertising are therefore an important part of the competitive process encouraging competition between suppliers both in terms of the price and non-price aspects of their products. This is common to many retail markets.

There exists the potential for misuse of branding by companies in ways that could distort competition. An example could be where a commonly owned group of businesses uses the brand of an upstream business to the advantage of a downstream business. This is particularly relevant where the level of competition in the downstream market may be less than effective, for example where a single firm dominates competition or where competition in a market is not well developed.

In the context of the electricity markets, a potential concern could arise if a supplier's marketing efforts were materially strengthened by its affiliated distribution business incurring costs on a re-branding exercise that created a link with that supply business. Price controls are expected to reduce the scope for this and Standard Licence Condition 39 in Distributors' licences provides further protection of supply competition in the event of such behaviour by licensees.

The presence of strong incumbent brands can also create barriers to entry and expansion where this materially raises the entry costs for potential or new suppliers. However, some recent new entrants have used their existing strong brand presence in other markets (e.g. banks and supermarkets) to enter the gas and electricity markets. Other new entrants have focussed on price and/or customer service rather than brand.

During 2003 and early 2004 several energy groups owning both electricity distribution and supply businesses proposed changes to their supply and/or distribution brands. In many cases these proposals reduced the difference between the branding of their respective supply and distribution businesses. Some of these proposed changes have now been implemented. These

changes gave rise to concerns that competition in energy supply may be adversely affected by the re-branding that was occurring. In response to these concerns, Ofgem reviewed whether current approaches to branding by a number of distribution licensees with supply businesses comply with the relevant electricity distribution licence condition concerning brand separation.

Licence framework

The existing licence obligations which relate to brand separation are contained in Standard Licence Condition (SLC) 39 (as modified in March 2002) of the electricity distribution licence. Paragraph 3 of SLC 39 requires that:

“The licensee shall at all times manage and operate the Distribution Business in a way calculated to ensure that it does not restrict, prevent or distort competition in the supply of electricity...”.

Paragraph 4 of SLC 39 requires a distribution licensee to have in place a compliance statement setting out how it intends to comply with, amongst other things, the requirement set out in paragraph 3. Insofar as this paragraph is concerned with the supply of electricity, the paragraph applies to all distribution licensees that have a supply business that is an affiliate or a related undertaking of the distribution licensee (termed the ‘relevant supplier’). Paragraph 6(b) of SLC 39 requires the compliance statement produced under SLC 39(4) to:

“...in particular (but without prejudice to the generality of paragraphs 2 and 3) set out how the Licensee shall:

...maintain the branding of the distribution business so that it is fully independent from the branding used by any relevant supplier or shipper;...”.

There is a link between the requirement in paragraph 3 of SLC 39 not to restrict, prevent or distort competition and the compliance statement to be produced under paragraph 4 which sets out how the distribution licensee will ensure compliance with paragraph 3. Therefore, when considering the branding of an electricity distribution licensee and the branding of any relevant supplier of that distribution licensee it is necessary to consider what, if any, the effect of any similarity of that branding may have on competition.

The introduction of the requirement for the licensee to set out how they shall maintain fully independent branding was introduced following a consultation in 2001 to review SLC 39 (formerly SLC 12)¹. A number of respondents to the consultation in 2001 commented that the present SLC 39 did not include a requirement to maintain separate brands for supply and distribution. This was seen by respondents as an important omission from the condition.

¹ “Separation of PES Businesses: Review of C12 Licence Obligations, Consultation Paper”, Ofgem, February 2001.

“Separation of PES businesses: Review of C39 of the proposed new distribution licence Proposals Paper”, Ofgem, September 2001.

Industry consultation

In January 2004 letters were sent to all licensees to whom Ofgem considered SLC 39 applied, as well as those who might be directly affected by a decision relating to this licence condition². Views were sought on the operation of SLC 39 in respect of the issue of branding separation in relation to the following three areas: implications of including elements of the supplier brand into a distributor's brand; benefits for customers of knowing that the two businesses are in common ownership; and the potential for an advantage to be conferred on suppliers with common branding across their distribution and supply businesses. Respondents generally held strong but opposing views on the importance of the licence condition. The responses to Ofgem's consultation are summarised below.

Implications of including elements of the supplier brand into a distributor's brand

Those respondents with supply and distribution businesses in common ownership said that competition in the electricity supply markets had developed since SLC 39 was amended in March 2002 and therefore considered such detailed restrictions were no longer appropriate. A number of respondents within this group also said that distribution issues did not feature in customers' choice of supplier.

However, supply companies without a distribution arm said that while the operation of the competitive market is gradually educating consumers, common branding, particularly between the incumbent supplier and the distributor, undermines the development of competition. The view was that the requirements within SLC 39 remain important in today's more mature market because the distribution business must be, and must be seen to be, a neutral party that provides the same level of service to all suppliers. Those distributors without a supply arm said that it is essential that any market rules are applied consistently, although this should not prevent such rules from being changed if that is in the interests of customers. They also said that wholly separate branding conveys a strong message of independence of staff, customers and suppliers, in line with one of the fundamental aims of the Utilities Act 2000.

Benefits for customers of knowing that the two businesses are in common ownership

Those respondents with supply and distribution businesses in common ownership argued that it was in the interests of customers to understand and more easily recognise where supply and distribution are in common ownership. The reasons they gave for this view were that providing consumer awareness of the identity of the local distribution business ensures that consumers contact the appropriate company when there are interruptions to the power supply, and a reference to the corporate group in the branding of the supply and/or distribution business may provide consumers with reassurance about the expected financial stability of these companies.

However, it was of concern to supply companies without a distribution arm that customers may attribute a benefit to contracting with supply and distribution companies in common ownership. They argued that there should not be any customer benefits arising from common ownership of supply and distribution. Moreover they considered it essential that the customer is not given any reason to suppose that one supplier has any unique or special relationship with the distribution business.

² Namely, suppliers without distribution businesses or distribution businesses without a supply arm.

One respondent said they had no reason to believe there had been any detrimental effect on customer confidence as a result of their re-branding away from that of the incumbent supply business.

Potential for an advantage to be conferred on suppliers with common branding across their distribution and supply businesses

Those respondents with supply and distribution businesses in common ownership said they had not seen any evidence that competition was adversely affected by the perceptions of customers of corporate affiliation between supply and distribution. They said that the market is vigorously competitive and all customers are aware of the opportunity to switch suppliers. They argued that the reasons behind customers switching supplier are well researched and are not influenced in any way by concerns about whether supply and distribution are in common ownership. One of these respondents also argued that it is the name of the company that is the important part of the brand, the visual representation of brand in terms of colour, font or even logo is considered far less important to customers than the name of the company.

Suppliers without a distribution arm said that shared branding enables the supply company to gain leverage from the incumbent distribution company presence in an area. They stated that perceptions about security of supply are one instance where unfair and unwarranted advantage can be obtained by such association. They argued that this perception distorts competition and creates barriers to new entrants with a less established name. They stated that in their view this also undermines the efforts of suppliers who have borne considerable costs to create an independent identity from the distributor upon acquisition of an incumbent supply company.

With such a wide difference between the two different types of views and a lack of empirical evidence supplied by respondents, Ofgem decided to conduct further analysis to consider whether competition in the electricity supply markets was being affected by the branding of electricity distributors who also have electricity supply licences.

Analysis

Given the requirement in paragraph 3 of SLC 39 that a restriction, prevention or distortion of competition in the supply of electricity be demonstrated, the review specifically examined potential evidence on the effect of existing branding practices on the domestic electricity supply markets. In Ofgem's view, if branding of distributors and suppliers is harming competition, the markets most likely to be affected would be the domestic electricity supply markets. The review also focussed on the potential effect on competition of those energy groups whose branding across the distribution and supply business did not appear to be as distinct when compared to the branding of other energy groups.

Competition in the domestic electricity supply market may be adversely affected by the lack of separate branding between a supply and a distribution business where the choices that domestic customers make are influenced by such branding practices to the extent that certain suppliers enjoy competitive advantages over other suppliers. Potential advantages in regions where the distribution and supply brands are similar could be that other suppliers find it more difficult to win customers away from suppliers with similar brands to the distribution company or these suppliers more easily acquire the customers of other suppliers. Ofgem therefore analysed

whether suppliers did appear to enjoy such advantages in a region where branding of the distributor did not appear to be as distinct from their own when compared to the branding of other energy groups. Ofgem's analysis looked for evidence of where behaviour or perceptions of domestic customers was likely to have been influenced by a failure to observe fully independent branding between a supply and a distribution business.

Evidence on customer behaviour was sought by considering:

- ◆ changes in market share
- ◆ customer gains and losses, and
- ◆ the nature and extent of complaints.

Customer survey evidence was considered to assess evidence on perception, in particular whether:

- ◆ the ability of customers to distinguish between the role of the supplier and that of the distributor differed between suppliers,
- ◆ there were differences in perception of the ability of suppliers to provide reliable electricity services to their home, and
- ◆ differences in the reasons for switching to a supplier could be linked to branding issues.

In all cases evidence was sought that might support or refute the view that any differences were attributable to failure to observe fully independent branding.

Evidence on customer behaviour

Changes in market share, gains and losses were compared before and after the re-branding of those energy groups whose branding across the distribution and supply business did not appear to be as distinct when compared to the branding of other energy groups. A comparison between regions where the energy group was the distributor and where it was not was also made. In the region where it was the distributor, Ofgem considered a case where the supplier was not the ex-PES supplier as Ofgem considered that the effects of supply incumbency would be hard to disentangle from any branding effects. This approach was taken to assess whether the group's re-branding had advantaged the supply arm in terms of its ability to acquire and/or keep customers.

In all cases the key observables; change in market share, gains and losses, all showed very similar trends between the two regions since re-branding. This included between regions where the energy group was the distributor and where it was not. This evidence appeared to suggest that re-branding had little effect on market share, acquisitions or losses in either of the regions.

The potential for common branding to reduce the ability of customers to distinguish between the role of the supplier and that of the distributor, creating possible confusion in responding to such issues as supply failure for example as well as influencing supplier choice was one rationale for the April 2002 modification of SLC 39. The review has therefore attempted to consider whether complaints statistics support the view that customer misunderstanding of supplier roles might

advantage some suppliers over others by considering the nature and object of complaints to energywatch.

According to energywatch, when consumers complain they are not generally aware of whom their distributor is and will often mistakenly attribute a problem to a supplier rather than the distributor. Unfortunately, this does not allow Ofgem to capture the extent of misperceptions and wrongful attribution of problems potentially caused by a failure to observe fully independent branding. Evidence in this area is therefore insufficient to undertake further analysis. However it does raise the possibility that customer association of a supply business and a distribution business may also have drawbacks in that a power failure could reflect badly on a supplier rather than on a distributor who in fact has responsibility for dealing with power failures. It also suggests some level of customer confusion between the distribution and supply roles.

Evidence on customer perceptions

Quantitative evidence provided by one respondent to the consultation³ supported the view that there is general customer confusion over the difference between the role of the supplier and that of the distributor. This confusion is further confirmed by survey evidence provided by respondents showing that customers believe suppliers with national brands are more reliable as physical suppliers of electricity compared to those with a regional identity. In addition, survey evidence held by Ofgem suggests that levels of customer confusion as to the roles of suppliers and network operators in ensuring power quality and reliability are very similar in the domestic gas supply market where branding between Transco and suppliers is not an issue.

Customer rating of the ability of different electricity suppliers to provide reliable electricity services to their home was also considered to assess whether branding may have favoured a supply arm in those regions where it was affiliated with the distributor. A comparison of reliability scores was made but no material difference was found between regions where the supplier was the distributor and regions where it was not.

Conclusions

The review has found evidence of general customer confusion in distinguishing between the functions of a distributor and those of the supplier. However, on the basis of the information currently available to Ofgem there does not appear to be robust evidence to suggest that the current branding practices adopted by supply and distribution businesses has operated to restrict, prevent or distort competition in the domestic electricity supply market.

Ofgem continues to believe that separation between the supply and distribution business in common ownership is important and will therefore continue to monitor the effect of branding between related distribution and supply businesses. Should evidence arise that indicates conduct in relation to branding is giving rise to anti-competitive concerns Ofgem will consider

³ 80 per cent of businesses and consumers gave the name of their billing company as the company responsible for the physical delivery of electricity; reliability of supply is the same or better with a company that has a national group identity compared to a regional supplier – 44 per cent agreed and 29 per cent disagreed (all data from August 2003).

whether any action is required under either SLC 39, or under other statutory powers available to it including those contained in the Competition Act 1998 or the Enterprise Act 2002.

Ofgem's analysis has focussed on the effect on the GB electricity supply markets and is based on analysis of customer perceptions and switching behaviour in the GB market. Competition in retail energy supply markets in GB is well established and there are a significant number of competitors in the market. Branding separation may be more important in other energy markets, particularly in continental Europe, where competition is at a less developed stage or is only just being introduced.

If you have any comments or questions on the contents of this letter, please feel free to contact me.

Yours faithfully,

Fran Gillon
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