OFGEM'S MARKET PROBE – RESPONSE OF E.ON UK PLC ("E.ON")

1. INTRODUCTION AND SUMMARY

1.1. We welcome Ofgem's analysis of the energy supply market and the key findings that the market is competitive, that it works well for most customers and that there is no collusion between suppliers. We believe this should dispel many of the concerns some stakeholders have had over the fundamentals of the market and allow the debate to be about how the market works and how it can be made to work better still. Our firm belief continues to be that working with the market is the best way to benefit all customers, including the most vulnerable.

1.2. We have structured the response into two key areas:

- Analysis in relation to Ofgem's proposed remedies, Actions 1-5, and our views on how these could affect the market.

- A further discussion of customers, specifically how we believe that all customers benefit from the market, whether they fit into the group that Ofgem classifies as "active" or otherwise, and of our view that all customers benefit from the pressure on suppliers to purchase well. This is backed up by research we carried out, discussed in a confidential Annex, which actually suggests that a much higher proportion of customers can be active than Ofgem imply.

1.3. In relation to the Actions proposed by Ofgem, our comments are largely supportive of Actions 1, 2 and 4 to improve the market through improving information and greater transparency. We have particular issues with aspects of Action 3, where we certainly do not believe that Ofgem has properly and sufficiently made a case to take greater powers in relation to the control of market abuse in the wholesale electricity sector. However, this aside, in the main we think Actions 1, 2 and 4 are targeted at improving the competitive process, allowing consumers to more effectively exercise choice and to improve the ability to select from available offers in a rational manner.

1.4. In relation to Action 5, we believe that this may have serious unintended consequences that could lead to a dampening of competition, rather than an increase in it. In addition, the burden that introducing such sweeping and interventionist regulation into the market would impose is likely to be disproportionate in light of the existing high levels of competition in the market. Accordingly, not imposing Action 5, and instead assessing other, more proportionate remedies, is justified.

2. DISCUSSION OF OFGEM'S PROPOSED REMEDIES (ACTIONS 1 TO 5)

2.1. The starting point for looking at the proposed Actions must be the findings that the retail energy market is highly competitive with all customer groups able to participate and switching rates which are far higher than those in other markets. Moreover, customers who switch, whether proactive or reactive, provide the discipline of the market on suppliers to meet all customers' needs.

2.2. However, as with any market, there are areas which can be improved and there are areas under Ofgem's proposals for Actions 1 to 4 which can be welcomed, as pro-market measures. To the extent that Actions are targeted at improving the competitive process, allowing consumers to more effectively exercise choice and to improve the ability to select from available offers in a rational manner, they could be a positive development in the market. We consider each of these in turn.

ACTION 1: Promoting more active engagement:

2.3. Looking first at the suggestion to promote more active customer engagement through clearer information on customer bills, an annual statement showing tariff and size of any premium paid, and an annual prompt to all customers of how to switch supplier. We support transparency and the provision of useful information to customers where it is well-targeted and does not overload customers (particularly vulnerable customers). We also want to keep bills as simple and understandable as possible.

2.4. We agree customers should find it easy to identify the information needed to get a reliable quote. The tariff name, and version, must therefore be clear on the bill so that a customer can reliably use a switching web-site or avoid error in a phone or doorstep quote. Our experience is that most customers provide bill information, which the quote tool uses to derive consumption and thus that there is no need for actual consumption data. The scale of this issue is unknown, but could be quickly established by discussion between suppliers, switching sites and consumer representatives. If most bills meet best practice, then we would expect suppliers to readily adopt it for all bills. If the issue is more widespread, we would support a licence change to achieve this.

2.5. In relation to consumption data, it would not be difficult to provide actual consumption over the last year for the majority of customers, although it would add to the clutter on customer bills, which will already have additional information from January 2009 due to the EU requirement for year on year comparison. Therefore, we would suggest no action now, but to research customers' usage of information on bills sometime in 2009, when the changes due in January have settled down.

2.6. In relation to an annual statement of products and proposals, this proposal goes beyond making it easy for customers to switch, to seeking to encourage switching. We believe that is going too far in a competitive market where switching levels are already established to be high. For example, if we look at a couple of previous cases where a switching prompt has been recommended as a remedy by the Competition Commission ("CC"), Northern Ireland Personal Banking and Domestic Bulk LPG, it is clear that the circumstances there were very different from here.

2.7. In Northern Ireland Personal Banking, the levels of switching of personal current accounts were found by one survey to be as follows: 11% of customers had switched over the last 5 years[1], switching equated to about 2 – 2.5% per year; a MORI survey in the same case suggested that 22% of total Northern Ireland population had switched over some time in the past, equating to around 1.5 – 2% a year since 2002[2]. In the Domestic Bulk LPG case, each year 3% of purchasers ended their contracts but only 1 in 6 of those (0.5% of the total customer base) did so to switch to an alternative supplier[3]. The levels of switching in these cases are so far away from those seen in electricity and gas, where 54% of electricity customers and 54% of gas customers have switched in the last five years[4], and switching is running at 16 – 17% per year and is on an upward trend[5], that this remedy must be considered to be disproportionate. The same comment must apply to the proposed annual prompt of how to switch.

2.8. However, in terms of the service that we offer our customers, we would consider offering them a "tariff health check" prompt – so that they were prompted to ask whether they were on the best tariff or payment method for their needs and could ring our call centre, to talk to an adviser who would understand their needs, to find out. This might also help with the targeting of our social product, as that contact might lead us to identify further vulnerable customers in need.

2.9. In terms of efforts to promote confidence in price comparison and switching sites, sites, we are not aware that there is a lack of confidence in sites for residential customers. Although they are 'for profit' bodies, they also have a commercial need for endorsement by the consumer body, which is therefore able to regulate them. We would therefore suggest no change in the supervisory role of Consumer Focus. If there are specific customer groups which are not well served, such as DTS customers, then Consumer Focus should be able to put pressure on sites to include them (for instance by awarding a star rating to sites offering an extended service).

2.10. Ofgem is considering whether there is scope to simplify the switching process, e.g. around debt blocking. We believe that the level of switching shows that the switching process already works well, and indeed this is Ofgem's own finding. Just over three-quarters of those who switched said the process had gone smoothly for them[6]. Although Ofgem presents evidence around concerns over switching, the very high levels observed in the market demonstrate that this is not having a significant adverse effect on switching.

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[1] Personal Current Account Banking Services in Northern Ireland , 15 May 2007, para 2.83
[2] Ibid
[3] Domestic Bulk Liquefied Petroleum Gas , 29 June 2006, para.4.14
[4] Ipsos MORI survey for the OFT, July 2008, quoted at Figure 4.3, Ofgem Report
[5] Ofgem Report, para 4.2
[6] Ofgem Report, para 5.9

2.11. In relation to the specific issue of debt blocking, Ofgem's figures show that the costs of credit management and bad debt are already a substantial burden on all customers, but the burden would be greatly magnified if customers who were not willing to pay were able to default by changing supplier. Once smart meter technology is implemented, suppliers could require prepayment on a house move and only offer credit terms solely at its commercial discretion. We would suggest that Ofgem start a review when there is some experience of smart meter implementation (it is not sufficient to just wait for agreement on implementation; research will be needed on customer reaction to prepayment offers).

2.12. In relation to Ofgem's proposal for a sustained customer awareness programme on the switching process, that appears to us to be a better and more proportionate remedy than requiring suppliers to invite their customers to switch from them, which Ofgem proposed above. Such a campaign could be targeted on specific customer groups and issues, for instance vulnerable customers as we suggest in Para 3.28.

ACTION 2: Helping consumers make well-informed choices

2.13. Ofgem proposes working with consumer groups and suppliers to try to develop better comparison methods, such as an easy to understand metric. We believe a simple comparison metric is a challenge (for example, Ofgem was not able to compare our Staywarm product for the purpose of its report into spending on social programmes) and would lead to products which are focused on the metric. For example, the FPAG proposal is to compare unit rates, which would be likely to lead to higher standing charges. One of the benefits of the competitive market is the high degree of innovation in products and choice to customers, including fixed, capped and guarantee products to manage risks of price changes and energy saver products to help customers reduce their energy bills. It would be unfortunate if this innovation were to be stifled[7]. Rather, customers should seek a quote for their own needs – as they would in the car insurance, home insurance and mortgage markets. As in those markets, the key requirements are that the quote is accurate (which we discuss below) and that customers are able correctly to articulate their circumstances (which has been discussed above).

2.14. The analysis that customers are unknowingly switching to higher priced deals is not robust (Ofgem's analysis for this report is essentially subjective – do customers think they got the savings they expected – particularly so when prices have been rising; whilst the analysis by the University of East Anglia[8] gives a lower range, 20-32%, and is heavily qualified by the authors). Nonetheless, there is no doubt that customers should receive accurate savings information (or awareness of any premium they are paying). Ofgem's research also shows that savings concerns are a barrier to vulnerable customers switching and these may well be exacerbated

[7] More so as smart meters are introduced and allow a greater variety of products.

[8] Wilson and Waddams-Price, Do consumers switch to the best supplier? CCP working paper 07-6, April 2007

by reports of switching not leading to savings. We recommended in our response to Ofgem's open letter on prepayment meters[9] that Ofgem should urgently investigate options for a saving always to be calculated – using a portable savings calculator, a telesales agent's access to a quote tool or a written statement during the cancellation period.

2.15. In relation to strengthening rules on suppliers' sales and marketing activities; we would strongly support efforts to prevent misleading marketing or sales activity and are very happy to work with Ofgem on the detail of this. A domestic customer entering into an agreement must be aware of the annual saving or premium of that agreement compared to his current contract and the supplier should take all reasonable steps to ensure that this is the case, whatever the sales channel. Confidence in sales integrity is even more important for vulnerable customers.

2.16. Smart meters will increase customers' engagement with and understanding of their energy supply (allowing them to use it most efficiently and encouraging take up of energy efficiency measures) and also remove many of the customer service issues, such as estimated bills, which can be an obstacle to customers taking full benefit of the competitive market. We are very happy to work with Ofgem and Government to facilitate an efficient roll-out of smart meters, the delay around which has dragged on for too long. We would urge Ofgem to agree to provide leadership in the delivery programme for smart metering roll-out.

ACTION 3: Reducing barriers to entry and expansion

2.17. Ofgem indicates that it will review regulatory obligations that could act as an undue deterrent to new entry or obstacle to small supplier growth and wherever remove them or make them less onerous. We are very happy to support this.

2.18. Ofgem proposes to require the "Big 6 suppliers" to publish separate regulatory accounts for supply and generation to improve transparency and make it easier for potential entrants to assess market opportunities at each point along the value chain. We are willing to support in principle the publication of separate accounts and would only caveat with the need to be proportionate in the regulatory burden that this imposes. This will depend on the degree of prescription that is mandated around the level of segmental information provided – we would ask that Ofgem consult on the detail of the requirement.

2.19. Ofgem indicates that it will begin, urgently, a programme of work to identify the underlying causes of low wholesale market liquidity and explore how best to increase this. We have previously agreed with Ofgem that the market was not perfect but also flagged that the market itself is doing something about it through the market design project (MDP) – we want a more liquid market. In this context, we note that the Nordpool issued a press release on 27 November to announce that the Power Trading Forum had chosen NasdaqOMX-nordpool as the recommended

[9] E.ON 11 July 2008

solution provider for the MDP, clearly showing that this project is moving forward[10]. The parties plan to establish the exchange within Q2 2009. This industry initiative has support from E.ON and other major energy players and should provide a cost-efficient, low risk route for new and established suppliers to buy power in the UK.

2.20. As a major market participant in both gas and electricity E.ON is keen to play an active role in exploring how we can assist in improving wholesale market liquidity. Collating and analysing liquidity data is currently a difficult task and information necessarily has to be drawn from a number of sources. Relevant data is not always readily available to existing market participants or Ofgem, let alone to new entrants, customers or other interested parties. It is therefore not surprising that some commentators have made inaccurate statements about current levels of liquidity. Indeed, in referring to discrepancies in evidence on traded gas volumes, the Business and Enterprise Committee commented in their July 2008 report that: "The absence of consensus on such a basic characteristic of the market makes it difficult to reach secure public policy conclusions on desirable interventions[11]."

2.21. We are therefore keen to ensure that existing publicly available liquidity data is made more visible[12], and where it is not, we think consideration could be given to capturing and collating data differently to provide more reliable information on the extent of trading across the whole of the forward curve. In so doing it should be possible to establish more 'definitive' measures of liquidity against which improvements can be measured. Overall, better information should also help to facilitate greater understanding and confidence in the market.

2.22. Ofgem indicates that it is seeking views on whether it needs potentially, new or additional, powers to guard against potential market abuses. We do not believe the case is made out in the present document, but we would be happy to work with Ofgem on the project it mentions about exploring how can increase liquidity. In the period January to October 2008, our data show that 1,100TWh were traded compared to a physical generation output of 260TWh, giving a liquidity measure of 4.2. For comparison in 2007 the figures traded were 990TWh, generation 330TWh, liquidity measure of 3, so year on year liquidity has significantly increased – though we accept that whether this increase can be maintained in the current economic climate is less clear[13].

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[10] http://www.nordpoolspot.com/Market_Information/Press-releases-list/No222008-NASDAQ-OMX-Commodities-and-Nord-Pool-Spot-chosen-to-deliver-Market-and-Clearing-Services-for-the-UK-Wholesale-Power-Market-/

[11] Energy prices, fuel poverty and Ofgem: HC 293-I

[12] For example, in relation to the gas market, E.ON proposed Uniform Network Code Modification 0219, "Publication of UK Wholesale Gas Market Liquidity Data"

[13] As the above trading volume figures relate to screen trades only and do not include direct bilateral trades or exchange trades, they will slightly underestimate actual trading volume and the liquidity measure

ACTION 4: Helping small business

2.23. Ofgem proposes a number of improvements to the conditions surrounding contracting with small businesses. We support simple changes, but caution that it is not straightforward to make comparisons between the SME and the domestic market and, as we discuss below, there are sigificant flaws in some of the analysis. Significantly, purchasing and experience of negotiating contracts, e.g. for lease of premises, wholesalers and insurance, is an inherent part of business customers' occupation and energy supply is just one of number of equally vital purchase requirements. There is no equivalent of the vulnerable group in the domestic sector within the SME sector[14]. A SME customer must be reasonably circumspect for their business to succeed and the majority of SME customers are well-qualified[15], contrary to the opinion expressed by FDS (report appendix 7, paragraph 1.20) "whose owners are not necessarily sharp astute business people".

2.24. The switching rate for SMEs is comparable to the domestic sector - in 2006 just over half of SMEs had switched electricity supply[16] and in July 2008 54% of domtesic customers had. The slightly lower churn rate for small businesses (13% v 16-17%) is consistent with the different market features – where business customers take an informed decision on their product (1 in 5 contact us) at the renewal anniversary date and may negotiate a new price (or switch). Equally, the fact that in a survey relatively few SMEs said they were searching out a better deal is likely to be down to the nature of the contracts. A small business customer need only seek out a deal at the end of the term of his existing contract, as for insurance contracts or lease agreements.

2.25. The statement (paragraph 10.14) that "The vast majority of switching is typically in response to an approach from a supplier or TPI" is inconsistent with findings presented in Figure 10.3 which shows that only 28% of gas and 38% of electricity SME customers agreed their existing contract following an approach from a supplier or TPI (also includes those proactively contacting a TPI) and a similar proportion, 23% of gas and 33% electricity (which excludes proactive TPI), agreed their contract online or by proactive call.

2.26. The 2008 Datamonitor SME Survey found that "Charges of negative behaviour leveled at suppliers by industry groups seem unfounded". Accordingly, it is of particular concern that Ofgem quote opinions expressed in a survey of only 70[17] customers as "evidence" of "common" bad practices (paragraph 10.40 and Appendix 7, paragraph 1.19). Taking each point in turn:

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[14] Although micro enterprises have some similar issues to domestic customers and are therefore protected by the Unfair Contract Terms Act and the Consumer and Estate Agents Redress Act.
[15] Federation of Small Businesses Lifting the Barriers to Growth 2006, customer research with responses from 18,939 SMEs.
[16] Ofgem Para 10.13, and Figure 4.3
[17] Insufficient to be robust, Datamonitor SME Buyer Survey 2008 sample size is 2,000.

"Win business through dubious sales practice"

2.27. The number of energywatch complaints on sales have reduced over time – specifically complaints on sales in 2006 were just over a quarter of the number received in 2004 and Cornwall Consulting[18] suggested that mis-selling by suppliers is not an issue in the business market, based on the higher figure. However, Cornwall did, in this report, recommend that energywatch sponsor a code of practice for TPIs covering charging principles, breadth of market coverage and clear communication of products offered and agreed.

2.28. Our own sales practices are of a high standard and energywatch statistics showed a low level of direct selling complaints for E.ON. We have a dedicated business channel to work with brokers and monitor their performance, to raise standards, investigate complaints and, where appropriate, cease working with the offending marketing agents. Our service level agreements require third party sales agents follow our internal practices. In addition they are required to inform the customer that they are independent of E.ON and to provide a verbal recording of every sales call.

"keep customers through one-sided contracts, with verbal contracts a particular source of confusion", and, "exploit the passivity of customers and the fact that they have other priorities"

2.29. The 2008 Datamonitor SME Survey concludes that "There are no major problems in how energy companies are contracting with SMEs", and "SMEs have not reported dissatisfaction with renewal windows or terms and conditions". E.ON offers fair and clear energy contracts, and terms and conditions of contracts are transparent at the point of sale[19] and renewal. Customers do have a responsibility to read their contract terms and, as business owners, should be aware of basic contract law – and their contracts with other parties and their obligations with regard to their own customers[20]. At point of sale they are free to ask questions and not to sign up if the contract terms do not suit their requirements – the nine key questions developed as part of Ofgem's Non Domestic Working Group provide useful guidance. We do, however, appreciate that all our customers are busy people. Our renewal process is designed to be straightforward and is no more onerous than a domestic mobile 'phone or home insurance contract. Equally, customers can choose to have our standard contract where they are only required to give 28 days notice.

"appear to make very little effort to retain customers through quality of service"

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[18] Cornwall Consulting – Business Energy Markets 2004, November 2004

[19] We use a script to ensure consistent high standards, this includes making the customer aware of the fixed term period, if applicable, and the renewals/termination process and the customer is asked to confirm that they understand the process and that they are entering into a contract.

[20] There has to be a question about how far you can help customers and how far they have to help themselves – at paragraph 10.23 of the Ofgem Report, Ofgem quotes a solicitor in Scotland as saying "I think it was just done on the phone. I don't think there was anything in writing to say you had to stay with them" – surely a solicitor might be expected to pay a little more attention to the terms of their energy supply?

2.30. We would challenge the claim (Ofgem Report, Appendix 7, paragraph 1.21) that companies do not seek to improve customer service. Energywatch's published complaints statistics[21] demonstrate improvements – the number of complaints in 2006/07 were less than half of the complaints received in 2004/05. We continuously improve our products and customer service in response to our own customer research and we have initiated discussions with trade bodies to discuss specific issues and understand what business customers value. We took part in Ofgem's Non-Domestic Working Groups and made changes to our practices as a result of these discussions and our ongoing customer research[22].

2.31. The report (paragraph 1.39) states "The above actions will help both domestic and small business consumers engage more effectively with the competitive market". However, as already discussed, SME consumers are different to domestic consumers and different issues arise. We would only expect the roll-out of smart meters to apply equally to business customers.

Action 4: proposals

2.32. In relation to the proposal to inform SME customers in writing of the key terms and conditions in their contracts, E.ON offers fair and clear energy contracts with the renewal process clearly explained. We would expect all business customers to be familiar with contracts and to be suspicious of any which are not clear. Moreover, the extensive use of brokers should in principle lead to a recommendation against obscure contracts – their commercial interest is in ensuring switching is easy. Nonetheless, the evidence is that some customers are signing without due care and we support a proportionate form of regulation, based on a requirement to provide principal terms to smaller customers.

2.33. In relation to the Accreditation scheme for switching sites and Code of practice for third party intermediaries, we take these together, since it is our view that switching sites are third party intermediaries which operate online and the code of practice we propose below should apply equally to switching sites.

2.34. TPIs provide a valuable service, particularly where the TPI has expertise which the customer does not have in-house, such as data preparation and getting quotes suited to their needs. For example, group SME, multi-site user groups and public sector groups might utilise TPIs as part of their tender process. However, there are a variety of TPIs who are largely unregulated, and can deliver an uneven customer experience. We support an initiative of providing a standard for reputable TPIs to sign up to through a common code of practice.

[21] Energywatch annual report 2006-2007

[22] for example, we reviewed all our correspondence for SME customers to make it clearer, introduced more channels for termination, stated content on renewals envelope to avoid it being mistaken for junk mail and provided energywatch with information on our products to assist them in keeping customers informed

2.35. Introducing an independent code of practice for TPIs would ensure a more consistent level of service and increase consumers' confidence in using TPIs. The key requirement is for consumer bodies to have confidence in the code and to actively promote it to business consumers (supported by suppliers, Ofgem and any broker trade association). We recommend that Consumer Focus take the lead in developing the code, and ensure consistency between the business market code and the code for residential market switching sites. The key emphasis in the code should be on clear presentation of information to users and it should therefore be relatively easy to police.

2.36. In relation to the proposal to institute a code of practice to govern objections and the switching process, small businesses benefit from the simple fixed price contracts which are available in the business market, unlike in the domestic market. However it is essential that the rule which allows this – for objection rights to be determined by contract - is fair to customers, and seen to be fair by customers.

2.37. Clearly Ofgem should follow up any reports (paragraph 10.31) that suppliers have objected in breach of contract. However, some contractual practices combined with the switching process can leave the customer locked in a new contract, even where the customer correctly followed his existing terms and conditions to terminate. For example:

- E4B contracts required termination notice 45 days prior to renewal and stated "should the customer fail to have effectively transferred supply to a new supplier within 7 days after the end of the Term, the Customer's Notice of termination under this paragraph shall be deemed ineffective and this Agreement shall in all respects be deemed to have automatically rolled on pursuant to this paragraph". The customer was therefore penalised by the tight timescale for a successful transfer. A fairer arrangement would see the customer on 'out of contract' terms, which reflected the wholesale market risks the supplier was exposed to, but did not restrict eventual transfer;

- An even more extreme example of this is Business Energy Solutions's Terms and Conditions which state that a customer must transfer to another supplier within 24 hours of their contract end date or they are rolled onto another contract.

2.38. Best practice should be that if a customer gives notice of leaving in accordance with the contract, and has paid any outstanding bills, then there are no further obstacles to that customer leaving.

2.39. The proposal to provide principal terms should lead to customers having a better idea of the risks in any contract form, but may not be sufficient as customers may not appreciate the difficulty of managing industry processes. We recommend that the code of practice for TPIs requires them to only promote contracts which follow the above best practice (suppliers would soon fall into line in only offering such contracts). The benefit of increased customer awareness of best practice could be achieved by suppliers, and other parties, promoting the one, TPI, code to all customers.

2.40. There is one further practice which disadvantages the majority of customers, due to the additional costs it imposes on suppliers. The Change of Tenancy (COT) flag is used inconsistently. In some cases, it is used fraudulently to break long term contracts, to avoid paying debts, or to avoid disconnection as a result of non-payment. This clearly has cost implications to the detriment of all other SME customers. Ofgem should issue new guidance on when a COT flag can be used. We suggest inclusion of a period of time within which the customer can be classed as 'new' in the premises. If this were set at four months, it gives ample time for a new tenant to choose a supplier and they will have received a bill.

2.41. The TPI code of practice should also incorporate an extension to the MRA guidelines to require greater care to establish the history of any COT. For instance, to go beyond the question "are you in a contract?" to also establish "When did you move in?", and "Have you paid and/or received an energy bill?". Where the customer has been in premises for more than 4 months and is not in a fixed period contract, an objection would not be raised.

2.42. These steps are quite far reaching and should lead to a significant increase in transparency for consumers and consistency in the TPI sector. If these measures prove insufficient, or indeed if brokers signed up to the code of practice further wished to ensure high sales standards by introducing an accreditation scheme for sales agents, we would support this.

ACTION 5: Addressing concerns over unfair price differentials:

2.43. Action 5 splits into two parts: Action 5a, under which Ofgem will propose a new licence requirement that differences in charges for different payment types must be cost-reflective, and Action 5b, a possible further licence condition for the "Big 6 suppliers" either prohibiting undue price discrimination or introducing a form of relative price control to ensure price differentials are objectively justified by cost differences. We comment generally first on Ofgem's view that Action 5 is necessary at all and then look at the two particular proposals.

2.44. The combination of the proposed cost reflectivity in differentials in tariffs by payment type and an obligation for no undue price discrimination is akin to relative price regulation. A price control is a tool to limit the exploitation of market power, and if designed appropriately can create incentives to reduce costs and thereby mimic the role of competition. However, it is not generally an appropriate tool to help encourage competition and has had problems in being applied to other competitive sectors.

2.45. A relevant example is the CC inquiry into banking services for small and medium sized companies (SMEs). This inquiry ended up with the imposition of remedies which required banks to pay interest on SME current accounts, or in the alternative to not charge transactional fees or account maintenance fees to SMEs.

As such, it took the form of price cap regulation. The results of this remedy are generally seen as having been unsatisfactory. The market share of the four main providers of SME banking services had been falling before the inquiry, and new entry had occurred, and the imposition of price caps may be seen as having halted this process. In 2007 these price caps were removed by the CC. Consequently, in a later investigation into issues with some similarities (the inquiry into personal current account services in Northern Ireland), the CC did not impose price cap remedies, but instead only used informational remedies.

2.46. A central contention (although not made explicit) in Ofgem's report is that the market for electricity and gas supply is insufficiently competitive. If the market is sufficiently competitive (or in a situation where it could be made sufficiently competitive by informational remedies), then there would be no need for Action 5. It is not best practice to apply price cap regulation (even relative price cap regulation) in situations where prices are broadly at competitive levels, since such a remedy would at best be ineffective whilst causing regulatory costs to be incurred and carry a substantial risk of reducing levels of competition in the market.

2.47. However, there is substantial evidence throughout Ofgem's report to the effect that the market is one which is effectively competitive, and where price regulation would therefore be a counterproductive remedy to apply.

- **Paragraphs 2.25 to 2.27 set out Ofgem's consistent findings that the market for retail energy supply is competitive.** This was found in reviews undertaken in September 2005, March 2006, and June 2007. In particular, the review in June 2007 found that "all segments of the market remained competitive. The spread between the most and least expensive suppliers had shrunk and more expensive suppliers had been forced to cut prices to stem accelerating customer losses." Ofgem does not appear to have presented detailed evidence why its conclusions on these issues have changed so significantly as to merit regulation being imposed;

- **Paragraph 7.2 sets out the experience of British Gas, which appears to have demonstrated that there is effective competition in the market.** It states that British Gas had historically priced above other suppliers in the market, but by early 2007 this position had been undermined by "accelerating customer losses" which forced it to cut its prices. This appears to be a clear example of competition in action—a company which has prices above those of its competitors loses market share until such a time as it brings its prices more into line with the market level;

- **Figure 7.4 also appears to demonstrate the effects of competition in action.** The gap in prices between in-area and out-of-area customers appears to be generally narrowing over time. Only one provider now has a gap between in-area and out-of-area of more than 10% (EdF Energy) whereas in mid 2005 three firms had such a gap. This is consistent with constraints being imposed on in-area pricing by loss of market share to rivals;

- **The average prices of the six major energy providers for dual fuel contracts are closely aligned (Figure 7.1).** This would be expected in a competitive market, as competition forces prices of the providers together. Close alignment of price rises would be expected in a competitive market, as such price increases will be cost related, and companies with high margins would be expected to lose market share. Similarly, the comments by Ofgem at paragraphs 7.26 and 7.27 regarding companies' hedging strategies are more suggestive of a competitive market, than any lack of competition. In a competitive market, it would be expected that all companies would have to use the same production strategy to minimise costs (which in this case includes suppliers' hedging arrangements). Furthermore, Ofgem notes that there have been occasions where adopting a different hedging strategy has had negative financial implications for the firm adopting it. This seems therefore to be evidence of competition in action;

- **Switching in the GB electricity and gas markets is considerably higher than most international benchmarks, as shown in Figure 4.2.** For example, in electricity, annual switching rates in the GB market are at least 50% higher than those in Norway, Sweden, the Netherlands, Belgium, Germany or Austria. Ofgem does not appear to have identified any European country with switching rates for gas or electricity higher than that in GB. This implies that competitive constraints in the GB market are likely to be stronger than those in these other countries. There appears to be no evidence from international comparisons that switching rates are in any sense 'too low';

- **Switching rates in gas and electricity also appear to be high relative to other products.** Amongst ten products, only one of the eight comparators (car insurance) had a higher rate of switching over the past five years than electricity and gas, whilst in several products (notably personal current accounts, but also savings accounts, credit cards and mobile phones) switching rates were much lower than in energy products; and

- **There does not appear to be evidence of excessive margins overall in the energy supply market.** As paragraph 8.77 indicates, it is more likely that the impact of relative price regulation would be to increase prices for some consumers whilst reducing them for other consumers, than price decreases such that no consumers lose out.

2.48. There thus appears to be limited evidence of any competitive detriment in gas and electricity which would be sufficient to act as a rationale for imposing any form of price controls upon energy suppliers. Action 5 seeks to remove price differentials between elements of a company's service offering that are not based on corresponding direct cost differentials. This final action may have serious unintended consequences that lead to a dampening of the current high levels of observed competition between the existing main suppliers. The premise that removing any price differentials that are not cost-related will improve effective competition is likely therefore to be mistaken, both from a theoretical perspective and on the basis of Ofgem's own evidence. Accordingly, not imposing Action 5, and instead assessing whether a more proportionate remedy is available, is likely to be justified. If the possibility of having price differences is removed through regulation, this is likely to lead to less churn. The incentives to compete for, and maintain, low prices for customers that switch actively may be reduced, thereby reducing economic welfare, directly for potential switchers and indirectly for all customers through the impact on energy purchasing (see section 3, below).

Action 5a - differences in charges for different payment types must be cost-reflective

2.49. Ofgem looks at differences in charges between direct debit and pre-payment meters ("PPMs") and standard credit or Quarterly Cash Cheque ("QCC"). Ofgem concludes[23] that PPM tariffs are, on average, broadly cost reflective and that standard credit customers are paying a premium over off-line direct debit that appears not to be fully cost justified.

2.50. Ofgem therefore says it "will propose" a new licence condition mandating cost-reflectivity. It is worth considering what "cost-reflective" means. We believe it is a broad test, which should be interpreted flexibly and does not mean reflect as in a mirror; it means that you should have taken account of the costs in formulating your prices. For example, Professor Yarrow, for GEMA in the Competition Commission case on enduring offtake arrangements in gas, indicated that, in his view the phrase "the price of interruptible capacity shall reflect the probability of interruption" did not require direct proportionality between charges and the probability of interruption[24]. Equally, the Electricity Internal Market Directive[25], provides in Recital 16 that the requirement for "non-discriminatory and cost-reflective balancing mechanisms" can be met through the "setting up of transparent market-based mechanisms" once the market is sufficiently liquid[26]. We would suggest, therefore, that cost-reflectivity should not be seen as a uniquely prescriptive standard, but rather as a factor to be taken account of.

2.51. Given the data presented by Ofgem, it must be concluded that any rebalancing would not in the aggregate benefit either pre-payment meter customers or direct debit customers. Consequently, the only potential beneficiaries amongst the payment type groups would be standard credit customers.

2.52. Figure 4.4 of the Ofgem Report demonstrates that churn amongst standard credit customers is in fact significantly higher than for direct debit customers, with around 2% of standard credit customers per month switching supplier. For standard credit customers who have switched and remained on standard credit, the presumption must be that in general they have made a conscious decision to remain on standard credit whilst switching, and consequently that there is not likely to be a market failure. Even for other customers, most will have the option of switching to a direct debit contract whenever they want, and consequently they

[23] Chapter 8, Ofgem Report
[24] Professor Yarrow's evidence, paragraph 65.
[25] Directive 2003/54
[26] Ibid, Recital 17

cannot be considered customers who are 'trapped' in a segment of the market which is subject to systematic price discrimination.[27]

2.53. In relation to E.ON, our differentials between payment types are broadly cost reflective[28]. In respect of standard credit against direct debit, this averages[29] £15 for single electricity (which is less than the average cost difference, which is £24); £25 for single gas (again less than the cost differential, which is £43) and £65 for dual-fuel, which slightly exceeds our average cost difference of £50. We believe this is reasonable, given the additional risk associated with standard credit payment.

2.54. We believe that these figures mean that the relative prices between standard credit and direct debit do not require to be adjusted as they are broadly cost reflective. Standard credit is also an evolving payment method, as suppliers seek to determine how best to manage the risks. In particular, suppliers are seeking to more accurately to price the risk into new customer acquisition, and if unable to do so would only be able to manage risk by requiring a security deposit, which would be a substantial barrier to switching. Standard credit is a common payment method in which competitive pressures will ensure that differentials to existing customers are broadly cost-reflective.

2.55. In relation to our differentials between PPM and direct debit or standard credit, these are, from the PPM customers' perspective, better than cost-reflective. In single electricity, in relation to standard credit, the difference in price is lower than the difference in costs (average bill difference £15, average cost difference £58); the same is true in relation to direct debit (average bill difference £30 (rounded), average cost difference £82). In relation to dual fuel, PPM/QCC, average bill difference £39, average cost difference £101 and PPM/DD, average bill difference £104, average cost difference £151. The same is true for single gas, PPM/QCC, average bill difference £25, average cost difference £43 and PPM/DD, average bill difference £50 (rounded), average cost difference £107.

2.56. This would tend to imply that, if Ofgem really meant to go down a strict cost-reflectivity line, we would be putting up more prices than we would be putting down, and that these prices would be going up to people on PPMs and single electricity and gas customers, the groups that Ofgem tends to view as being more vulnerable.

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[27] The exception would be those customers without a bank account. A potential remedy would be an ability to pay direct debits from post office card accounts.

[28] The figures presented here are based on recent analysis of call durations, as well as volumes, by product holding and payment method. PPM calls are particularly complex and lead to the higher differentials than previously assessed. Further work is required to identify which calls relate to debt-recovery, and might therefore be allocated to credit payment methods, and also which credit payment method – this will affect standard credit to direct debit differentials. Note that the type of customer on each product holding - single electric, single gas and dual-fuel costs – will differ, but customer research would be required to understand how this affects call volumes and durations.

[29] For 3300 kWh electricity; 20,500 kWh gas. E.ON's differentials are percentages, so are higher in pounds for gas than electricity.

Action 5b: prohibiting undue price discrimination or introducing a form of relative price control

2.57. Ofgem seeks views as to whether a prohibition on undue discrimination is proportionate to the issues raised in the report and would help, rather than hinder, progress towards a more competitive market.

2.58. The type of pricing behaviour identified by Ofgem (i.e. price discrimination) is commonly observed in most competitive sectors. Insurance companies give discounts for those who switch; online tariffs may be lower (or have additional discounts). Mortgage companies offered good rates for those re-mortgaging without altering the terms of those who did not seek to change their arrangements.

2.59. In general, price discrimination can be driven by two commercial incentives:

- serving more customers to maximise asset utilisation in order to aid fixed cost recovery; and
- business-winning aims, by designing tariffs to match the customer characteristics (second degree price discrimination).

2.60. Therefore, price discrimination is often seen in a commercial context and can give more vigorous, head-to-head competition. The Ofgem Report has arguably not provided sufficient grounds for imposing Action 5 as it has not shown the energy retail market to be lacking competitive dynamics; for example Ofgem's own analysis has shown price dispersion and margins to be relatively low, which is consistent with a competitive market.

2.61. In a regulatory context, prohibiting undue price discrimination is generally understood to mean that any differences in the price offered to different users need to be justified on the basis of cost and other characteristics of the user. It is usually imposed on a dominant firm (often the incumbent monopolist) in a liberalised market, or in the context of constraining the flexibility of a vertically integrated firm to set access prices in a manner which disadvantages its downstream competitors. Such concerns arise from the way in which a dominant firm might use tariff differentials to hinder the ability of competitors to challenge its market position. Ofgem's analysis has not demonstrated the presence of dominant firms in the energy retail market, and neither is there evidence of foreclosed access to inputs necessary for independent retailers (e.g. access to upstream supplies, networks, ancillary services, or customers). This reinforces the argument that there is little, if any, justification for imposing Action 5.

2.62. This issue is extremely important as the regulatory burden of having to be prepared to justify every aspect of competitive activity would be huge, with any decision at risk from different costing methodologies (for example, how to assess the costs of more frequent changes of premise, as raised by Ofgem in 7.57). The unique feature of the energy supply market – the management of billions of pounds of wholesale energy costs – adds a new dimension of complexity with the impact of different churn rates and the treatment of marginal and average costs, potentially leading to significant differences between customer segments, and between different suppliers assessment for the same customer segments.

2.63. Beyond the issue of payment methods, already discussed, Ofgem has raised three areas of potential discrimination:

- Electricity v gas
- In-area v out-of-area
- Off-line v on-line

2.64. The first of these areas is unique to energy, as there is no equivalent in other markets of the underlying issue of strong customer preference for dual-fuel contracts linking electricity and gas pricing. This area is also the most important. In Ofgem's calculation it gives rise to the largest differential and potentially has the most perverse impact – a reduction in competitive pressure on the highest priced and largest supplier in the market. We consider this in detail below, but first note that in the other areas, the energy supply market offers more choice and less discrimination than where there is a comparative effect in other markets:

2.65. All the differences arise from customer choice, albeit with no means of distinguishing between a preference (e.g. for standard credit terms or a familiar brand) or a consequence of differences in customer engagement with the market (e.g. on-line price comparison or access to doorstep sales).

2.66. The energy supply market is also distinguished by being relatively new; market opening was only 10 years ago. Its natural evolution would likely see:

- Even greater competitive pressure and customer choice, as customers become more comfortable with switching, suppliers and switching sites innovate; and
- Increased segmentation and differentiation, on the basis of customer attitude. Smart meters add to this trend.

2.67. The balance between these two trends is uncertain, but certainly one outcome might be much higher differentials between customers, as in the insurance market.

2.68. Different issues arise in relation to each of these areas but fundamentally our view is that these are actually reflective of a competitive market working and that although more needs to be done to remove remaining barriers for customers who have not switched, preventing these differences would stifle competition between existing players and potentially introduce artificial distortions[30], as discussed above.

2.69. This is recognised in the Ofgem Report where it is noted[31] that the alleged premium that it says is earned across all the companies by differential pricing, estimated at £1bn[32], exceeds the average annual net margin that the suppliers earned. Therefore it is noted that if the differentials were eroded, it would have to be through a rebalancing between prices rather than a straightforward decrease for the most impacted customers.

Electricity v gas

2.70. Residential gas pricing in GB is dominated by two factors:

- The brand strength of British Gas, which means that competitors have to offer a substantial saving to gain customers

- The need to manage and respond to rising wholesale costs, which have been significantly higher for gas than electricity.

2.71. Over the period 2005 – 2007, these factors have led, as Ofgem have noted, to low or negative gas margins, although the situation can change quickly with movements in wholesale and retail prices and currently our gas and electricity margins are similar (only £10 difference, but more on a percentage basis as gas bills are higher). Our gas margins have to enable us to compete with BG on single gas or dual fuel products. Our electricity margins have historically been higher – but the Report does not indicate that Ofgem believes they are excessive, just that they are higher. Our overall Retail profitability is negative. But if we raise gas prices to align our gas and electricity margins we will be less competitive vs British Gas – who are the highest priced, largest supplier: a perverse outcome of the probe.

2.72. We do not believe that mandating a regulated solution would help progress to a more competitive market since the reduction in competitive pressure on BG would be substantial. Suppliers will still wish to compete, but will have to develop new techniques. Some of these, such as increased effort to tackle barriers to switching amongst those with the strongest brand loyalty to BG will benefit all customers, although as we stated in our evidence[33] are already underway. Others, such as innovative propositions for new customers, would tend to negate the intent of the regulation. Overall, the unintended consequences of Action 5 could be high and may undermine the effectiveness of Actions 1 and 2, which are designed to lead to more engagement with the market, by leading to much lower churn by removing

[30] The consequences for payment method differentials according to methodology are an example, as shown in footnote 28. The methodology for energy costs, in particular, whether it is average, hedged, cost or marginal, forward curve, could also distort pricing if regulated.

[31] Para 8.77, Ofgem Report

[32] We do not accept the £1bn, it is very sensitive to movements in energy costs

[33] Para 2.12-2.13

scope for all (or most) price differences currently observed. The resulting market outcome would then be cost reflective differentials, but higher prices overall and less switching.

2.73. The disadvantages of a regulation on undue discrimination need to be weighed against the potential development of a market based approach:

- Consumer Focus, through the recognition they give to switching sites, can encourage development of comparison features which increase customers' ability to choose unduly low priced gas offers. The two necessary steps are (i) display of separate electricity and gas options with dual-fuel quotes; and (ii) easy to access display of off-line offers, for increased transparency to occasional internet users;

- Media interest in price differentials, increasing customer awareness of the need to consider separate offers and potentially leading to adverse comment on any supplier with untoward differentials;

- Increased cross-sell to single gas customers (5.5M British Gas, 2M non-BG[34]), accelerated by Ofgem's proposals to increase market effectiveness which we discuss above;

- Increased awareness of the potential benefits of proactive engagement with the market amongst single electricity customers (whether on-line or by phone), reinforced by the developments highlighted above; and

- Continual improvement of hedging strategies, recognising the differences in wholesale and balancing market risk and in competitor position between electricity and gas. This process of continual improvement in managing risk increases the downward pressure on wholesale prices, to all customers' benefit.

2.74. These steps may not materially affect the level of differentials, as these are currently relatively small (order £10 to £50 depending on methodology[35]), but they should certainly ensure that the way the market evolves is positive, giving increased opportunity to non dual-fuel customers to benefit from the market.

2.75. We would like to comment specifically on one set of customers highlighted in the Ofgem Report, dynamic teleswitch (DTS) customers. We believe this is a more complex issue that Ofgem have suggested. There is a clear difference between off gas grid customers with a standard (single or two rate) electricity supply and DTS customers:

- For the former, switching rates are high (1.6M out of 2.7M) and although the relatively high cost of field sales in rural areas (but not in blocks of flats without a gas supply) makes it more important that all possible steps are taken to

[34] Ofgem Report Table 3.1

[35] £ or % equivalence, between electricity and gas.

encourage proactive switching, the energy supply market works as well as any. Networks and meter operations pricing of course favour rural customers, further reducing the case for any regulation on discrimination between electricity and gas customers as discussed above;

- Switching amongst DTS customers is low (10%). The segment is also much larger than we believe anyone had realised, at 1.6M households. The market opportunity is therefore greater also and we believe that this should allow market-based remedies to be effective in increasing choice. We recommend:

  - Ofgem should increase transparency over the potential of the DTS market - how many households are on each DTS structure in each region and what the average consumption is;

  - Consumer Focus should encourage switching sites to provide price comparison for DTS customers; and

  - Suppliers provide Consumer Focus with a short commentary on their DTS products, which allows Consumer Focus to brief other stakeholders (and avoid the situation we believe has happened of DTS customers being encouraged to be proactive, and then discouraged by lack of choice).

In area v out area

2.76. As we showed in our evidence to Ofgem, suppliers have quite different brand strengths around the country and customers place quite different value upon brand familiarity. Differences between in and out of area are therefore to be expected, with a further driver being the pricing policies of British Gas and the local ex-PES. We believe that some differential is justified, taking into account the weaker brand position out of area which means we have to offer more to win customers.

2.77. These differences are normal, and quite small. As Ofgem's Figure 7.4 showed, our average in-area margin is below the average and towards the bottom of the pack (only SSE is lower). It is 1% higher than out of area (we are not able to comment on Ofgem's calculation of 3% - but would not expect an exact match due to variations in assumptions on electricity and gas demand profiles). However, these averages conceal quite large variations between out of area regions. In addition, Figure 7.4 shows that these differentials are narrowing due to the effect of competition working in the market.

On-line v off-line

2.78. On-line is effectively a separate market from off-line and although we understand the commercial interest of switching sites in encouraging a move to on-line it is potentially a barrier to occasional internet users that on-line and off-line prices are presented together. The on-line energy market thus reflects the situation in many other markets, where those who are prepared to be the most active and shop around gain the greatest discounts, whether dual fuel or single fuel[36]

2.79. As we stated in our evidence[37] the on-line market has yet to mature. There have been some very low prices, but we are not aware that customers who switch to them do not receive the full benefit[38]. E.ON's on-line prices offer a guaranteed discount to our standard prices and in this period customers only see an increase if standard prices increase.

2.80. The complexity of comparing products, and hence of any regulation, is illustrated by comparison of on-line and off-line sales. On-line could be £100 lower in price, but has comparable lifetime profitability due to lower sales cost and lower churn. Neither of course is likely to have the same expected lifetime profitability as a longstanding customer, but that is true of all markets – retaining a customer can be worth several times the value of acquiring one.

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[36] Ofgem notes that suppliers offer significant potential savings to electricity-only customers who purchase online

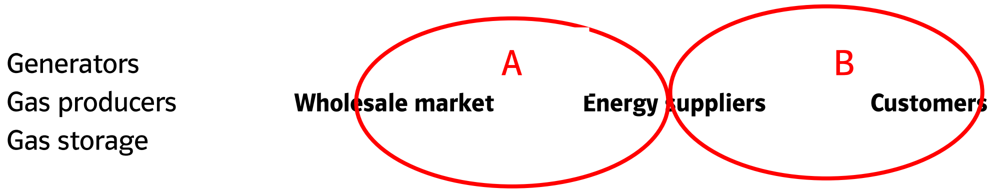
[37] E.ON Para 4.11

[38] Ofgem Para 7.74

3. DISCUSSION OF HOW CUSTOMERS BENEFIT FROM THE MARKET

Energy supply market and purchasing

3.1. The Ofgem Report highlights the two supplier relationships within the supply chain:



3.2. Relationship B, between suppliers and their customers, is very similar to that in other markets - customers have choice and more active customers get more out of the market than less active customers. Energy is different from some other markets in that every household is a customer (unlike say car insurance), but it is not fundamentally different. How well the energy supply market works can be compared against other markets.

3.3. Relationship A, between suppliers and their principal supply chain is unique. As we said in our response to Ofgem's call for evidence (the "Response"):

"Suppliers in the retail energy market seek to manage billions of pounds worth of highly uncertain costs, which make up 50 - 60% of the retail price to domestic customers, on behalf of those customers."

3.4. Some other markets have a similar scale of cost variability, for example, petrol retailing and mortgage provision. However, in both of those markets the uncertainty is wholly passed onto customers. In petrol, pump prices change frequently, whilst in the mortgage market the cost of many products will vary with changes in the Base Rate and customers have to choose the right product for them, for example, a fixed rate product, to manage the risk[39]. No other market seeks to do this and there is much misunderstanding in the media and amongst stakeholders about this role that suppliers play.

3.5. In this respect the energy supply market cannot be compared with any other market. (Uninformed) commentators would prefer to see an approach more akin to the petrol sector, where price changes are passed straight through to customers, whether increases or decreases. The degree of volatility that this would imply continues to make this an unattractive approach for the domestic sector – although it is not an impossible route for this market to go down.

[39] Capped or fixed price products are an increasing feature of the energy market but are only 7% of our customer base.

3.6. Ofgem's analysis of supplier pricing and hedging strategies (Paras 7.1 - 7.21) is clear and explains well why the most recent falls in forward wholesale costs may not lead to lower retail prices.

3.7. We wish to comment on three observations, two in Chapter 7 and one in Appendix 3 of the Ofgem Report:

Para 7.12 *"we have found no analysis why these profit expectations might be sustainable in an effective competitive market"*

3.8. Indeed, it is certainly not clear what profit expectations are *attainable* in the circumstances of the current market. The management of risk within the energy supply market is unique and no two years will be identical in the combination of circumstances of gas supply and storage, electricity supply, world coal, gas and oil prices and weather pattern, there is no robust analysis of what profit may be sustained over the long term in the market. It is questionable, therefore, whether there can be a sustainable profit expectation. Superficially, one might arise with a period of wholesale price stability, but this will itself be an exceptional period given the underlying uncertainties in the wholesale market.

3.9. Having said that, although the Ofgem Report later (Chapter 8, paras. 8.16 et seq.) discusses what an efficient level of profitability in retail energy might be, it reaches no conclusion as to whether or not current profitability levels are consistent with an effectively competitive market. Equally, it does not actually state that the level of margin discussed as an aspirational target in paragraph 7.12 (between 4 and 10%) is itself unacceptable.

3.10. As a matter of fact, of course, aspirational profit targets are no more than that when we are not actually making any money in retail – we will make a loss this year, and it will be challenging to make a profit next year.

3.11. Looking at Appendix 3:

Appendix 3, para 1.51 *"the link between the price of domestic energy and the price of oil on international markets needs to be broken or weakened – or at the very least energy companies need to provide clear arguments and evidence for the link."*

3.12. It is true that, whilst the UK gas and power prices are not directly linked to oil, there is a strong indirect influence which arises from the link between oil and gas prices and the increasing imports of gas from the Continent. Continental gas market conditions are therefore of increasing significance for UK gas and power consumers given that gas prices are a major determinant of power prices as discussed above. However, electricity and gas wholesale prices are themselves also influenced by a number of factors other than world oil prices – notably prospective tightness in electricity generation capacity and in gas import capacity which have meant that UK energy prices have not fallen as sharply as world oil prices. Therefore, whilst wholesale oil prices on the spot market have fallen by 12% since

01/01/07, wholesale gas prices have risen 49% and wholesale electricity prices have risen 57%

3.13. The right response to this from a UK and continental perspective is to encourage alternative sources of gas, particularly LNG, to increase investment in gas storage and to diversify away from sole or excessive reliance on gas in the power market, by investing in alternative generation, including renewables, nuclear and cleaner coal-fired generation.

3.14. Moreover, the rationale for a relationship between oil and gas is clear for two sources of upstream gas – in the North Sea it reflects production trade-offs, whilst for producers from other jurisdictions like Norway and Russia, it is their preferred form of indexation. Appendix 3 is a little disingenuous here, as the statement quoted above implies that it is the same energy companies who supply end customers in Great Britain as are responsible for the oil/gas link – the truth, of course, is very different since, as purchasers we are also subject to the link insisted upon in contracts that we conclude with producers.

3.15. Looking at paragraph 7.27, which, with paragraph 7.26, discusses how suppliers seek to align their strategies for purchasing energy with those of their competitors, particularly British Gas, Ofgem comments:

> ***Para 7.27*** *"Retail supply businesses competing vigorously to secure the cheapest possible wholesale energy, in order to out-perform the competition and secure a commercial edge in the retail market as a result would, we believe, be in the long term interests of consumers."*

3.16. Ofgem accepts that this is a rational risk management strategy, and indeed comments that there have been times when a supplier has adopted a significantly different hedging strategy and suffered financially as a result. However, it also suggests that this weakens the competitive pressures on wholesale energy prices. We cannot agree: for customers to realise the full benefits of retail competition, suppliers have to purchase well and this is exactly what suppliers seek to achieve. In addition, as we have already discussed under Action 5 above, the comments by Ofgem at paragraphs 7.26 and 7.27 regarding companies' hedging strategies are more suggestive of a competitive market, than any lack of competition. In a competitive market, it would be expected that all companies would have to use similar production strategies to minimise costs (which in this case includes suppliers' hedging arrangements).

3.17. Suppliers have an exposure of hundreds of millions of pounds to movements in the wholesale markets. It is vital to manage this risk by being not too far different from competitors' position, but this is a dynamic process. Suppliers' trading arms continually seek to read the market better than their competitors, but it is not a sustainable competitive advantage – no-one can consistently beat the market. However, the effect of this series of trading decisions is a more competitive wholesale market and hence upstream prices.

3.18. In our view, the key requirements for consumers exist in the Great Britain energy market:

- the wholesale market is competitive;
- competition in the retail market increases pressure on wholesale prices; and
- the wholesale market continues to deliver security of supply.

3.19. It appears that the real issue leading behind stakeholder concerns is the reluctance to accept that the fundamentals mean that the era of low energy prices in Great Britain is over.

Energy supply market and customers

3.20. The energy supply market is easier for customers to engage with than most other markets, as borne out by the facts, observed by Ofgem, that at least 75% of customers who take gas and electricity have switched energy supplier at least once, equivalent to just under 20 million households[40]. The market has higher switching rates than any other market than car insurance[41] (which market also has a smaller proportion of vulnerable customers).

3.21. Our research actually suggests that a much higher proportion of customers can be active than Ofgem imply. We discuss this in detail in Annex B, but the key conclusion is that most customers *will* engage with the market and therefore play a role in ensuring price discipline on suppliers and in encouraging product innovation. The evidence in the Ofgem Report reveals that the average differential between in-area and out of area pricing has narrowed[42], and that differentials between pre-payment meter prices and direct debit prices have also fallen during the last round of price increases[43]. Ofgem has previously commented in relation to pricing behaviour that "customers have punished firms offering high prices and poor service by switching supplier"[44]; this evidence is repeated in the Ofgem Report[45]. The evidence, therefore, suggests that high prices are not sustainable.

3.22. Some price differences between customer segments are inevitable in a competitive market, as more active customers tend to find better deals than less active customers. The regulatory challenge is not to stop this happening, by preventing differences, but to remove those barriers which deter less active customers.

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[40] Paragraph 4.1, Ofgem Report
[41] Ofgem Figure 4.3
[42] Ofgem Report, Figure 7.4 and paragraph 7.36
[43] Ibid, Figure 7.5 and paragraph 7.47
[44] Ofgem Factsheet 69: Britain's competitive energy market 04.07.07, page 3.
[45] In relation to British Gas, see paragraph 7.2

Vulnerable Customers

3.23. We welcome Ofgem's highlighting of issues faced by vulnerable customers in the probe and also the research Ofgem has conducted into barriers to switching which particularly affect vulnerable customers.

3.24. The greater variety of sales channels means that the energy market is more open for vulnerable customers than, for instance, home insurance. Nonetheless it could be more open still and an important test of the appropriateness of any remedy is how it will benefit vulnerable customers.

3.25. We therefore support those measures which are simple and build confidence; and are sceptical of measures which will tend to overload customers. To recap on our earlier comments, we support:

- Clear tariff names;
- Advice on payment method;
- Raising confidence in switching;
- Ensuring confidence in face to face selling by requiring a firm quote; and
- Roll-out of smart meters.

3.26. We do not support adding more to bills or additional bill enclosures or a price metric. The latter would seem particularly unhelpful to vulnerable customers. E.ON, for instance, has five products which offer benefits matched to different aspects of vulnerability and which cannot readily be included in a single metric:

- Staywarm – fixed payments, be warm;
- Age Concern – with a trusted partner;
- Guarantee – reassurance that will save if switch from British Gas;
- Fixed – certainty over price; and
- WarmAssist – social offer, with CaringEnergy support.

3.27. Moreover, the simplest price metric (average customer bill) would be quite misleading for single customers, who form a relatively high proportion of the vulnerable, but tend to have below average consumption. Potentially, the metric could suggest that all new products are higher cost than the customers' current bill, whereas the opposite is true for the target audience of non-switchers – almost all offers offer savings.

3.28. We recommend that Ofgem use the near certainty of savings for customers who have never switched as the basis of an awareness campaign to increase confidence amongst neighbours and relatives that it is worth seeking to help vulnerable customers to switch.

3.29. These specific measures for vulnerable customers do not alter the paramount importance of the supply market continuing to be highly competitive, exerting downward pressure on energy costs. This is the most important issue for vulnerable customers.