



**Consumer
Focus**
Campaigning for a fair deal

Consumer Focus response to Ofgem's consultation: Project Discovery

November 2009

About Consumer Focus

Consumer Focus is the independent champion for consumers across England, Wales, Scotland, and for postal consumers in Northern Ireland. We operate across the whole of the economy, persuading businesses and public services to put consumers at the heart of what they do.

Consumer Focus was formed on 1 October 2008 through the merger of three organisations – energywatch, Postwatch and the National Consumer Council (including the Scottish and Welsh Consumer Councils). We are a statutory organisation that works in a devolved setting, with work priorities varying across different parts of the country, by all working to common strategic goals.

Through campaigning, advocacy and research, we champion consumers' interests in private and public sectors by working to secure fairer markets, greater value for money, and improved customer service. We have a particular focus on the interests of consumers in markets that are 'designated' by Government as requiring additional consumer advocacy. Currently these include energy and postal service consumers.

Consumer Focus also has a commitment to work on behalf of vulnerable and disadvantaged consumers, and a duty to work on issues of sustainable development.

Executive Summary

- Project Discovery highlights the scale of challenges facing the GB energy market given the current economic situation.
- It is useful to undertake scenario analysis to assess how the energy market may respond to a range of risks and challenges, some of which are unprecedented, and we welcome the work and the profile being given to it by Ofgem.
- It is evident that whatever the future situation in relation to required investment, energy supply and carbon impact, energy users in GB face significant increases in their energy bills over the next 10 to 15 years.
- One of our concerns is that energy companies do not combine these additions to bills with unjustified price behaviour regarding wholesale price falls.
- In this response Consumer Focus makes a number of recommendations for future action and to guide future work undertaken as part of Project Discovery.
- This response is non-technical and therefore we do not challenge the method used by Ofgem. We note, however, that there is limited information provided about the method used. We have commented on some of the assumptions made by Ofgem.

Consumer Focus response to key issues

'We should worry less about the lights going out and more about the costs to the economy of running our energy system on the edge'¹

Dieter Helm

1. Introduction

In April 2009 Professor Dieter Helm, a respected energy expert, highlighted concerns regarding the current economic situation and the implications for the energy market in Great Britain. The recession has cut demand for energy and, therefore, emissions. In turn, this has eased concerns over security of supply for the near-term. However, the recession has also delayed critical investment in energy infrastructure. The latter effect may be more important over the long term.

Professor Helm also states that consumer bills would rise as consumers pay for the initiatives required for Government to meet its agreed carbon emission targets. He suggests that estimates of these increases are conservative.

It is encouraging that Ofgem has acknowledged these issues in the Project Discovery scenarios and has looked at the impact on consumers' energy bills. The suggested increases range from 14 per cent to 60 per cent during the next 10 to 15 years and are of concern to Consumer Focus. We recognise that Ofgem has no remit to set prices; however, we would prefer a more even spread of the costs between consumers, taxpayers and shareholders for measures proposed to deliver the low carbon agenda.

While we note Ofgem's attempt to define 'secure and sustainable' energy supplies, we believe equal emphasis should be given to the 'affordability' of energy supplies (although Ofgem has recognised affordability is an important issue).

In this response to phase one of Project Discovery, Consumer Focus will outline our understanding of the consequences of these scenarios and the anticipated price increases for consumers. Further, we will make recommendations for action to ensure consumers are treated fairly.

Consumer Focus is concerned that this report may result in 'carte blanche' for energy companies to increase prices. Ofgem must remain vigilant on pricing and, in particular, on how costs are passed on from the wholesale markets to retail customers. Consumers should feel confident that energy companies are prevented from using these scenarios as a means to hide unfair pricing.

¹ http://www.timesonline.co.uk/tol/comment/columnists/guest_contributors/article6101205.ece

In future phases of this project Ofgem intends to review market arrangements, identify policy responses and test them against the scenarios and stress tests. However, immediate action is required including proposals that should include routine and forensic scrutiny of energy company pricing.

The focus of this response surrounds six key issues:

- demand side management and energy efficiency
- market arrangements
- implications for bills
- climate change
- fuel poverty and the stress tests

2. Demand side management and energy efficiency

Consumer Focus believes that demand side management (DSM) and the necessary engagement by consumers with the market needs to be explored. This will help increase understanding of the implications of Ofgem's scenarios, the impact of a prolonged economic downturn and more generally to plan for more secure energy supplies into the future.

Ofgem has identified upward pressure on electricity demand from electrical vehicles and heat pumps. The case that enhanced efficiency will balance the growth in demand for electricity needs to be clarified. It is worth highlighting how the seasonal and daily demand profile for new demand can be managed with acceptable capacity margins.

Future increases in demand must be managed in consultation with customers. Otherwise there is a risk of substantial additional demand on winter evenings, when the peak usually occurs.

As outlined below there is great scope for demand side reduction and much of this will be on the use of gas.

We believe policy has not sufficiently addressed demand reduction, despite it representing a low-risk policy for carbon reduction. It is also the most cost effective method of reducing carbon, as demonstrated by the McKinsey marginal abatement work². The energy demand reduction project being managed by Ofgem has tended to stall and the impacts of time-of-use metering and the applicability of rising block tariffs are only just being explored. Britain is also a long way behind European partners such as Germany and Sweden, where government intervention has led to far higher standards of thermal efficiency in domestic housing.

Energy efficiency can also play a significant role in combating fuel poverty (see Section 6).

The Department of Energy and Climate Change's (DECC) recent call for evidence³ into delivering secure low carbon electricity examines the energy efficiency refurbishment of British homes, 'smart demand', patterns of consumption by customer groups, ability to shift and reduce demand in periods of peak demand, and balancing the system. We welcome many of these goals; for example, the better integration of supply and demand policies, the greater emphasis on demand policies and the breadth of policies designed to meet its ambitious carbon targets.

² http://www.epa.gov/oar/caaac/coaltech/2007_05_mckinsey.pdf

³ <http://www.decc.gov.uk/en/content/cms/consultations/electricsecure/electricsecure.aspx>

However, Government could go further. It should bring forward its programmes, a number of which are not due to start until 2012, raise the level of its ambition, set more stringent target standards for energy efficiency improvement and focus more on improving the homes of low income households. Delivery mechanisms are particularly important. The current system is ad hoc, piecemeal and confusing to consumers. The supplier-led model is not sufficient for the scale of the task and we are calling on the Government to replace it with a model based on public sector leadership and strategic oversight.

The DECC call for evidence also only provided limited discussion about how people will respond to the initiatives proposed to control demand. There appears to be a general assumption that energy demand will be reduced as a result of 'offers' of 'smart demand' and energy efficiency measures, but there remain questions about behavioural response and how consumers respond to information and prices.

DECC and others are too optimistic in their predictions of demand reduction. For example, some consumers will reduce energy consumption in some areas so that they can 'afford' more consumption in another area. This 'rebound effect' is also understood and requires attention.

The Scottish Government has undertaken detailed work in this area. The Scottish Energy Efficiency Action Plan outlines key concerns and issues. It states that '...in the domestic sector, for example, take-up of energy efficiency measures has been disappointing despite successive campaigns, and behaviours have actually become more energy-intensive. The increasingly pro-environmental attitudes expressed in surveys, such as the Scottish Environmental Attitudes and Behaviours Survey 2008, do not appear to make it through to sufficiently altered actions'.⁴

The report goes on to outline reasons for this discrepancy. For example, people lack cost motivation to save energy (due to current energy pricing structures), and there is limited emphasis or information on the benefits of energy efficiency and the financial costs involved. These results are backed up in the report *Consumer Power* released by the Institute for Public Policy Research in September 2009.⁵

The results of this research support our calls for the Government, regulator and others to create awareness and engagement with consumers, overhaul delivery mechanisms, engage voluntary and community organisations in supporting consumers, and institute rigorous consumer assurance and accreditation schemes.

Recommendations

- Ofgem should review and build on existing understanding of consumers' attitudes and responses to low carbon policies.
- Such a review should address delivery mechanisms, particularly in relation to the effect on consumer engagement, financing of measures, consumer incentives and regulation.

The outcome of these actions would inform debate and policy.

⁴ <http://www.scotland.gov.uk/Resource/Doc/918/0087767.pdf>

⁵ <http://www.ippr.org.uk/>

3. Existing market arrangements and price signals

Ofgem assumes in the scenarios that market participants respond adequately to market signals. We agree that this may occur to an extent on the supply side but we have concerns, shared with independent generators and small suppliers, with the actual operation of the GB market both in terms of lack of liquidity and inadequate price signals. For example, Jeremy Nicholson from the Energy Intensive Users Group says ‘...on the face of it, a market that does not really have any room for independents, or anyone who isn’t substantially vertically integrated, must have something wrong with it.’⁶

Consumer Focus is concerned at the low level of liquidity in the electricity wholesale market and has further concerns with liquidity in the wholesale gas market.⁷

As we stated in our response⁸ to the Ofgem discussion paper *Liquidity in the GB Wholesale Market* in July 2009 we believe a high proportion of trade occurs within integrated supply and generation firms. The trading that does exist seems to be concentrated in prompt and shorter dated contracts with a dearth of trading further out on the forward market. We believe this has kept prices high and compromises the value of information on forward trades and prices. We are concerned that these higher prices have been passed on to consumers.

The structure of the wholesale electricity market makes it difficult for new entrants to enter unless they are already large or vertically integrated. This is because of high penalties if suppliers fail to correctly predict supply at gate closure in the electricity market, which disproportionately affects smaller participants. In addition, supply-only and generation-only firms are seemingly excluded from the market, thus stifling innovation and slowing the penetration of more diverse and low carbon technologies (for example, Combined Heat and Power).

Smaller market participants have voiced concerns about increases in consumers’ bills. For example, Drax stated in their response⁹ to the Ofgem Liquidity consultation that it is the way in which market participants operate that requires scrutiny (ie, the use of internalised trades). Without credible investment signals entering the market, new entrants will not invest; a large proportion of trade pricing is hidden by the internalised trading structures of the vertically integrated companies.

We have identified important issues regarding liquidity of the market and price signals. These will affect analysis of Ofgem’s scenarios and have an ongoing impact on the functioning of the market.

A sufficiently robust carbon price is a pre-condition of the investment needed to decarbonise UK energy, be it via the European Union Emission Trading System (EU ETS) or other methods. The Government, rather than Ofgem, must take the lead and provide the price signals needed to make renewables economic without more subsidies from consumers. We support Ofgem’s advocacy work for contracts for difference for carbon and renewables as one way to address this.

⁶ Quoted in New Power Issue 10 November 2009.

⁷ Our concerns about lack of liquidity in the gas market relate to two issues, one that key stakeholders have raised continued concerns with us and secondly, in 2008 the BE Select Committee raised some concerns about lack of liquidity in the gas market which have not yet been fully addressed.

⁸ <http://www.ofgem.gov.uk/Markets/WhIMkts/CompandEff/Documents1/Consumer%20Focus%20Response%20to%20discussion%20document.pdf>

⁹ <http://www.ofgem.gov.uk/Markets/WhIMkts/CompandEff/Documents1/Drax%20Response%20to%20discussion%20document.pdf>

Ofgem should consider the implications of a failure to achieve such a robust carbon price in its Project Discovery work, and this might constitute a stress test.

The scenarios paint a picture of investment decisions by the power generation industry which efficiently anticipate and meet a shortfall in capacity a few years hence. The forecast wholesale prices, coupled with the relatively low EU ETS prices means we are sceptical that new investment will be forthcoming.

Ofgem's scenarios review anticipated gas and electricity demand and predict price increases. While the consultation acknowledges that the demand and supply outlook in the near term is comfortable, we believe additional emphasis should be made of this point.

It is our understanding that until 2015/16 demand growth is expected to be relatively low, from a lower base than previously expected, and that the GB market will be oversupplied.

National Grid has lowered its forecast for peak power demand by approximately 10 per cent from its May 2008 Seven Year Statement to the August update of the May 2009 Seven Year Statement. As a result it is now forecasting that peak demand in 2015/16 will be about seven per cent below the 2007/08 level. As a result of this reduction in demand, as well as new generation capacity coming on line, reserve margins look comfortable until 2015/16¹⁰.

Furthermore, the recent analysis from the International Energy Agency in its World Energy Outlook shows that the annual under-utilisation of inter-regional pipeline and LNG capacity could result in a gas glut until 2015, resulting in further downward pressure on gas prices¹¹.

Given the changes to supply and demand fundamentals that have occurred in the last two years, the current forward curves which exhibit a steep contango would appear to be overvalued. There is, therefore, a possibility that the forward wholesale prices for 2010/13 will adhere to current levels.

We are concerned that suppliers may use the Project Discovery report to justify continuing delays to decreasing retail gas prices when there is strong evidence that price reductions that have occurred should be passed through now.

If action is not taken to address these issues, the situation could worsen with the possible merger or withdrawal of one of the Big 6 energy suppliers.

We recommend that Ofgem:

- Announce their promised range of proposals to improve liquidity in wholesale markets as soon as possible.
- Consider the implications of a failure to achieve a sufficiently high carbon price in its Project Discovery work.
- Consider the impact on its scenario analysis of a fall in forward prices from gas and electricity from current levels.

¹⁰ UK Utilities, Contango Collapse – Look for Regulated Exposure, Morgan Stanley (13 October 2009) p4

¹¹ http://www.iea.org/press/pressdetail.asp?PRESS_REL_ID=294

4. Implications for consumers' bills

The Government should recognise that significant public expenditure is required, rather than expect consumers to foot the entire bill of transition. Benefits and burdens must be proportionately borne between all parties – shareholders, tax payers and consumers. We often hear the argument that it does not matter whether consumers or taxpayers pay the bill – the bill still has to be paid. However, general taxation represents a more progressive method of raising finance than levies on bills, particularly given that energy costs represent a significant proportion of low-income household expenditure.

Where consumers are expected to fund action it must be clear and transparent how and what costs are incurred. Consumers' financial liability must be limited and a series of checks and balances put in place to ensure quality and efficiency at every level. It should not be assumed that consumers should automatically pay for inefficient or unnecessary investments. Without checks and balances, green investment risks being viewed cynically by consumers – as a ploy to justify unfair price increases.

By funding the transition to a secure low carbon energy economy through energy bills rather than general taxation, people on low incomes or in hard-to-heat homes are paying disproportionately for a strategy that has broad societal and environmental benefits.

In this context, Consumer Focus considers that the significant revenues raised from ETS auctions should be directed towards low carbon transition, particularly in improving the energy efficiency standards of low income households.

Energy consumers can play one or more of three roles in the move to a low carbon energy market:

- reducing consumption or making more efficient use as end-users of electricity, gas and heat
- potential generators of electricity and heat
- funders of Government programmes through taxes and levies, and of industry investment via their bills

Each role includes costs that may be hidden to the consumer and involve varying levels of choice. A more informed and aware consumer may be better placed to make decisions about how best to participate in the energy market (ie, when dealing with a supplier of energy or when considering energy efficiency measures).

At this time the majority of consumers have limited understanding or awareness of the components of their bill, the various levies and charges, and how to be more energy efficient. As a growing proportion of energy bills are fixed and these fixed costs are rising, Ofgem could investigate the possibility of making these costs more transparent to consumers.

Consumer Focus believes there is a need to differentiate between different consumer groups to better understand the impacts of increasing prices and distributional impacts. For example, the scenarios may impact differently on the fuel poor and different social groups, especially those on low incomes. Others who will be affected are those who live in rural or remote areas and those who are off the gas grid and dependent on heating oils or Liquid Petroleum Gas (LPG).

We would support some more innovative work by Government and Ofgem about how market arrangements could better protect these consumer groups from the more serious impacts of rising prices. We acknowledge that Government recently responded to the Efra select committee report on energy efficiency and fuel poverty, in which Ofgem's work on rising block tariffs was noted. This work highlighted the potential these tariffs have at motivating consumers to reduce energy use while not adversely affecting the fuel poor.

We would like to explore the implications of providing consumers with a 'protected block' of consumption upon which levies are not applied. This work needs to be undertaken in stage two of this project. For example, certain components of bills could be protected from increases and new levies, or the proposed renewable heat incentive levy could only be applied if a household had declined opportunities for energy efficiency measures.

There must be regulation and intervention to ensure fair impact of financial burdens on energy consumers.

The impact of changes on consumers' engagement with the energy market needs to be better understood. As more of the bill is fixed and the commodity component of the bill is reduced, there could be less scope for competition on price in the traditional sense. Smart metering and smart grids will enable a range of new tariffs to be offered: time of use, demand reduction/automation tariffs, feed-in tariffs and renewable heat tariffs, to name a few. The market is likely to become more complex and potentially harder for consumers to navigate. How switching to a better deal can be delivered in this new environment, and the effectiveness of the market measured in this context, needs to be considered.

We would support further investigation of these issues by Ofgem.

Recommendations

- Ofgem should work with Consumer Focus on initiating a public discussion on 'Who Pays?' for the investment required. This should lay down principles for expenditure, ie, what should be paid for by consumers and what should come from the public purse.
- Where costs are borne by consumers, measures need to be put in place to ensure that these are fair and efficient. Benefits and burdens should be borne proportionately by all parties.
- Mechanisms need to be established so that consumers do not foot the bill for inefficient or mistimed investments.

5. Climate Change

Consumer Focus is concerned about the lack of explicit reference within the Project Discovery scenarios to the impact of climate change on energy networks and demand.

While the UK Government is aiming for an agreement in Copenhagen that limits climate change to a two degree centigrade temperature rise, current climate science and greenhouse gas emissions suggest that we should prepare for rises of four degrees centigrade while cutting emissions.

The risks arising for the energy sector from inevitable climate change include:

- sea level changes causing flood risk to energy facilities
- a reduction in summer precipitation resulting in competition for cooling water for power plants
- sustained high temperatures driving demand for cooling
- warmer winters, reducing demand for heating
- hotter summers, affecting equipment ratings and reliability
- climate events causing disruption to the transport of fuel to power stations or homes, and other aspects of the energy infrastructure

Due to the range and potential magnitude of these impacts, Consumer Focus would like to see the inclusion of 'climate change adaptation' in Ofgem's understanding of sustainable development and therefore in Project Discovery, particularly in terms of stress tests and investment costs.

Consumer Focus' understanding of the impact of climate change on today's consumers can be found in our recent report *Adaptation to a changing climate*¹². In the report we have used the recent Climate Projections (UKCP09) to examine the impacts of climate change on consumers' long-term investments, but are now looking at how those changes affect the future of essential services.

Recommendation

- Ofgem takes account of climate change projections in the Project Discovery scenarios and addresses these important issues in its stress analysis.

¹²http://www.consumerfocus.org.uk/Media/ViewFile.aspx?FilePath=1_20091006133348_e_@_Adaptationtoachangingclimate.pdf&filetype=4

6. Fuel Poverty

Energy bills are expected to increase substantially under all four of Ofgem's scenarios. Even where assumptions are made that energy efficiency measures are effective (leading to less energy use), bills will still increase. This may lead to a significant increase in the number of households living in fuel poverty.

Figures released by DECC in October 2009 predict that the number of fuel poor households in England could rise to 4.6 million this year. Assuming fuel poverty in Scotland, Wales and Northern Ireland rose at the same rate as England, this translates to 6.6 million fuel poor households in the UK. We are, therefore, facing a fuel poverty crisis. If accurate, the Project Discovery scenarios and Low Carbon Transition Plan proposals will deepen this crisis unless there is a substantial change in policy.

In the Project Discovery document, Ofgem does not address the impact of rising energy bills, increasing fuel poverty and the consequences for security of supply and market arrangements. These consequences include:

- Lower demand than anticipated or predicted as consumers involuntarily reduce energy usage, with subsequent social implications such as ill health, social exclusion and the rapid deterioration of housing stock.
- Increasing debt and disconnection, thereby increasing debt burden on other consumers.

Other factors to consider:

- The fuel poor often use less energy but are expected to pay the same fixed costs as higher income consumers for energy efficiency measures.
- Consumers are not treated equally when it comes to paying energy bills. If you have the internet at home, a bank account and enough income to have your energy bill paid through online direct debit, you can receive the least expensive deal from your energy company.

We acknowledge that Ofgem is looking at these issues and recently released a discussion paper on energy charges and energy efficiency that looked at the potential effectiveness of various pricing structures to encourage an uptake in household energy efficiency. However, more could be done in this area.

The Government proposes to mandate reduced electricity prices for low income pensioners over 70 because they have a 'high incidence of fuel poverty'. Consumer Focus supports this move. However, specially commissioned research¹³ shows that other types of households are just as likely to live in fuel poverty. It is also of concern that increases in energy prices experienced by producers, manufacturers and others such as supermarkets will be passed onto consumers for the goods and services we need.

We are currently calling for Government to implement a number of actions which Ofgem should consider in their own deliberations, including:

- Introducing a national energy efficiency programme that focuses on fuel poor households with the aim of bringing homes up to a target Energy Performance Certificate B standard.
- Taking account of the real inflation rate for essential services such as utilities when up-rating benefits, pensions, tax credits and the minimum wage.

¹³ From an unpublished Consumer Focus report "Cutting the energy bills of the fuel poor". Publication is forthcoming.

- Producing a new and costed Fuel Poverty Plan, in consultation with stakeholders, that sets out how it intends to meet its statutory duty to eliminate fuel poverty, particularly in light of the predicted rise in fuel prices.

Recommendations

We recommend that Ofgem:

- Assesses the likely impact of the Project Discovery scenarios on the level of fuel poverty in Britain. It should work with Government to develop policy responses that enable the Government to hit its statutory fuel poverty targets.
- Continues to develop its Social Action Strategy, particularly in exploring the potential to further reduce differentials between repayment/Standard Credit and on-line Direct Debit tariffs (beyond the new 'undue discrimination licence condition).
- Further develops its work, outlined in the *Can energy charges encourage energy efficiency?* discussion paper, with respect to identifying the distributional implications of providing a 'protected block of consumption' to which Government 'levies' do not apply and the potential to 're-shape' levies so they have a more progressive impact.

7. The stress tests

We believe the stress test approach Ofgem has taken is correct and helps test the robustness of the electricity and gas system in the face of short or medium term shocks within the scenarios presented.

However, while the consultation recognises that a potential stress test could be lower than anticipated availability from current nuclear generation capacity, no such stress test has been modelled. We believe that such a test should be undertaken when considered against the historical variability of nuclear generation load factors.

Consumer Focus also recommends that further work is undertaken to understand the degree of industrial and commercial demand curtailment that could be reasonably expected to materialise in the effect of tight system margins.

Conclusions

We commend Ofgem for undertaking this valuable work. Overall we believe the scenarios are plausible and sensible. Our recommendations are our attempt to ensure Ofgem undertakes important and necessary work as a prelude to the future stages of Project Discovery to ensure consumers are treated more equitably.

We are aware that the Government intends to amend Ofgem's remit as part of the forthcoming Energy Bill. When and if Ofgem receives extra powers it falls to the regulator to act on its remit and take the action highlighted in our introduction; Ofgem must provide a heightened level of vigilance over pricing and how companies pass costs from the wholesale markets to retail customers. Consumers need to be confident that energy companies cannot use these scenarios as a means to hide unfair pricing. We also need Ofgem to protect the more vulnerable consumer from the impact of prices increases.

We are keen to continue our working relationship with Ofgem and to focus attention on the issues highlighted in our response.

Consumer Focus response to Ofgem's consultation: Project Discovery

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